Audit risk alert - 1999/2000; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

AUDIT RISK ALERTS

AICPA

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Audit Risk Alert—1999/2000

General Update on Economic, Auditing, Accounting, and Other Professional Developments

Notice To Readers

This Audit Risk Alert is intended to provide auditors with an overview of recent economic, auditing, accounting, and other professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted on by any senior technical committee of the AICPA.

George Dietz
Senior Manager
Accounting and Auditing Publications

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In This Year's Alert...

- *What is the purpose of this Audit Risk Alert? What are the risks associated with the audit process? Page 7*
- *What are the current conditions in the U.S. economy? Page 8*
- *What are some of the matters you should consider when planning your audit? Page 11*
- *When do you need to be independent? How do you determine whether or not you are independent? Is there help available for your independence questions? Page 16*
- *What are some of the significant findings of the COSO fraud report? How can you benefit from understanding the report's findings? Page 22*
- *What is the auditor's responsibility to detect fraud in a financial statement audit? Page 28*
- *What is the Year 2000 Issue? How will it affect your audits? Page 32*
- *What does the new SEC Staff Accounting Bulletin have to say about materiality? What effect will it have on financial statement preparation and audits? Page 42*
- *What are some of the common engagement deficiencies cited in peer reviews? Page 47*
- *What are some of the issues to be considered in audit sampling? Where can you obtain practical guidance for sampling? Page 48*
- *What should you know about communications with audit committees? Page 50*
- *What are the recommendations of the Blue Ribbon Committee report on audit committees? Page 53*
- *What is continuous auditing? Page 57*
- *What are Assurance Services Alerts? Page 58*
- *What is SysTrust^{SM}? Page 59*
- *What new auditing and attestation pronouncements have been issued this year? Page 61*

- *What new accounting pronouncements have been issued this year?* *Page 66*
- *What is the Independence Standards Board? Have they issued any standards that you must follow?* *Page 78*

Table of Contents

AUDIT RISK ALERT—1999/2000 7

Introduction 7

Economic Environment 8

Audit Issues 11

Planning the Audit 11

Independence 16

COSO's Fraud Research Report 22

Fraud—A Closer Look 28

The Year 2000 Issue 32

Materiality—SEC Staff Bulletin 42

Peer Review—Common Engagement Deficiencies 47

Audit Sampling 48

Audit Committees 50

On the Horizon 53

Improving the Effectiveness of Corporate Audit Committees 53

Continuous Auditing 57

Beyond the Audit 58

Assurance Services Alerts 58

SysTrust(SM) 59

New Auditing and Attestation Pronouncements 61

New Auditing Pronouncements 61

New Attestation Standard 62

New Audit Issues Task Force Advisory 63

Recent GAAP Pronouncements 66

New FASB Prouncements 66

New AICPA Statements of Position 71

EITF Consensus Positions 75

Independence and Other Ethics Standards ... 78
The ISB's First Standard ... 78
AICPA Professional Ethics Rulings and Interpretations ... 80

PITF Practice Alerts ... 85

Recent Exposure Drafts ... 87

Guides and Audit Risk Alerts ... 92
AICPA Audit and Accounting Guides ... 92
AICPA Industry Audit Risk Alerts ... 93

Other Accounting and Auditing Team Publications ... 94

Auditing Practice Releases ... 97

AICPA Services ... 97
Order Department (Member Satisfaction) ... 97
Accounting and Auditing Technical Hotline ... 98
Ethics Hotline ... 98
World Wide Web Site ... 98

APPENDIX A — THE INTERNET—AN AUDITOR'S RESEARCH TOOL ... 101

Introduction

What is the purpose of this Audit Risk Alert? What are the risks associated with the audit process?

This Audit Risk Alert is intended to help auditors plan their 1999 year-end audits. Successful audits are the result of a number of factors, including the acceptance of clients with integrity; adequate partner involvement in planning, supervising, and performing audits; an appropriate level of professional skepticism; and the allocation of sufficient audit resources to high-risk areas. Addressing these factors in each audit engagement requires substantial professional judgment based, in part, on a knowledge of professional standards and current developments in business and government.

Throughout the audit process, from the initial consideration of whether to accept a client to the issuance of the audit report, auditors should consider overall engagement risk. According to the Professional Issues Task Force (PITF) Practice Alert 94-3, *Acceptance and Continuance of Audit Clients*[1], engagement risk consists of the following three components:

1. *Client's business risk*—The risk associated with the entity's survival and profitability
2. *Audit risk*—The risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated
3. *Auditor's business risk*—The risk of potential litigation costs from an alleged audit failure and the risk of other costs (whether an audit failure is alleged or not), such as fee realization and the effect on the auditor's reputation resulting from association with the client

[1] See the "PITF Practice Alerts" section for further information.

Although this Audit Risk Alert does not provide a complete list of the risk factors to be considered, and the items discussed do not affect risk in every audit, it can be used as a planning tool for matters that may be significant for a specific audit. During the conduct of all engagements, auditors must remember that their paramount responsibilities are to boards of directors, shareholders, creditors, and the public. This requires the traits that are the hallmarks of auditors: independence, objectivity, and integrity.

Economic Environment

What are the current conditions in the U. S. economy?

The economy's robust growth in recent years continued unabated through 1999, making this the longest period of economic expansion since the end of World War II. Much of this growth has been attributed to ongoing business investment and advances in technological innovation. However, consumer consumption has lately taken the lead in powering this expansion. Some key statistics relating to the overall performance of the economy follow:

- Gross domestic product (GDP)—which measures the output of goods and services produced by labor and property located in the United States—surged to 6.1 percent in the final quarter of 1998 (the fastest growth rate of the '90s). GDP then moderated to 4.3 percent and 2.3 percent, respectively, in the first and second quarters of 1999. Estimates for third-quarter GDP showed an increase to 3.9 percent. Estimated annualized GDP for 1999 is 3.5 percent.
- Consumer confidence levels were at record highs. For example, consumption of goods and services increased 6.8 percent in the first quarter of 1999, a gain considered substantial by most economists.
- Unemployment dropped to 4.2 percent in September, a twenty-nine-year low. Inflation remained low at about 2½ percent.

- The Dow Jones Industrial Average (DJIA) broke through the 10,000 threshold, reaching record highs over 11,000 at some points in the year. To put the enormity of this event in perspective, note that this milestone was reached in less than 3½ years after the DJIA first closed above 5,000.

- Interest rates inched up during the year, but remained near historically moderate levels. The prime rate (the rate many banks charge their top customers, and to which other interest rates are often linked) reached 8.25 percent, and 30-year fixed mortgage rates remained under 8 percent. The Federal Reserve raised its federal funds rate (the interest rate at which banks lend to each other overnight) during 1999 to 5.25 percent from 4.75 percent.

Some observers believe that little or nothing in the short term can break the momentum of this economy. Others worry that the Year 2000 Issue will drag down growth early next year. However, this may be an overestimation of the impact of a specific event (as with the Asian crisis) on an economy as large and dynamic as that of the United States. Nevertheless, the consensus is that positive conditions are expected to continue into the year 2000, giving us yet another year of economic expansion. However, the expansion is likely to be tempered by the cumulative effect of economic factors, including tight labor markets, a weaker dollar, rising consumer debt, and higher inflation. Expectations for some key economic indicators in the year 2000 include the following:

- GDP is likely to drop slightly to 3 percent.

- A modest rise in inflation, to 3 percent, is expected.

- Interest rates are also likely to increase slightly. Prime is likely to edge up to 8¾ percent. Thirty-year Treasuries are expected to reach 6¾ percent.

- Unemployment is expected to remain below 5 percent.

Keep in mind that these statistics represent the economy as a whole. When using information such as this—for example, when performing analytical procedures in accordance with Statement on Auditing Standards (SAS) No.56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329)—you should understand that there will be variations based on unique regional or industry circumstances. Not all sectors of the economy, and not all industries, are benefiting equally, despite overall economic prosperity. For example, although the Asian crisis did not cause the widespread economic disruption that had been anticipated, it has left the agricultural sector badly battered. And, while the stock market has surpassed all expectations, it is interesting to note that the majority of returns on stocks in the Standard and Poor's 500 index during the prior year were attributable to the fifty largest companies in the index. Many companies in that index actually lost market value. So remember, as always, adopt an approach of professional skepticism when planning and performing your audit. Look "beyond the numbers" to gain a deeper understanding of the implications of economic events on the audits you perform.

In addition to economic issues, a number of noteworthy events affecting the profession occurred this year. Among them were the release of the COSO report on fraudulent financial reporting; the issuance of Independence Standard No. 1, *Independence Discussions With Audit Committees*, by the Independence Standards Board (ISB); and the Blue Ribbon Committee report on improving the effectiveness of corporate audit committees. We will discuss these events, their implications, and, where applicable, use them as an opportunity to review our understanding of existing standards in these areas.

Finally, 1999 brought us yet another year closer to the year 2000. A complete discussion of the Year 2000 Issue, along with a discussion of the guidance developed by the AICPA, is presented in the "Audit Issues" section of this Alert. In addition, auditors should be alert to concerns that may arise this year. For example, some computer systems may have been designed to assign special meanings to date entries coded *xx/xx/99* (sometimes used for "dummy" transactions intended to test software modifications), and therefore may not process these transactions correctly.

Failures may also occur this year if systems perform calculations into or beyond the year 2000.

Executive Summary—Economic Environment

- Robust economic growth continued in 1999, fueled by business investment, technological innovation, and consumer consumption.
- Key economic statistics clearly show the strength of the overall economy. Remember that when assessing the specific audit implications of economic events, such statistical information may not reflect variations that arise from unique regional and industry circumstances.
- Beyond economic issues, a number of noteworthy events relating to audit committees, fraud, and independence occurred this year.
- 1999 brought us another year closer to the Year 2000 Issue. Are you prepared? See the "Year 2000 Issue" section of this Alert to find out what you need to know.

Audit Issues

Planning the Audit

What are some of the matters you should consider when planning your audit?

The successful audit begins with successful planning. Therefore, planning the audit is always a primary consideration. Thoughtful, meticulous attention to detail in the planning phase will result in a blueprint for an efficient and effectively performed audit engagement. Although the unique characteristics of each engagement will require equally unique audit plans, here are some general pre-engagement and planning considerations you'll need to keep in mind for most of your audit engagements.

- *Client acceptance*—Is this client for you? Statement on Quality Control Standard (SQCS) No. 2, *System of Quality Control for a CPA Firms' Accounting and Auditing Practice*[2] (AICPA, *Professional Standards*, vol. 2, QC sec. 20.14)

[2] Firms that are enrolled in an AICPA approved practice-monitoring program are obligated to adhere to quality control standards established by the AICPA.

provides that "Policies and procedures should be established for deciding whether to accept or continue a client relationship...." These policies and procedures should provide reasonable assurance that the client does not lack integrity. Practice Alert No. 94-3, *Acceptance and Continuance of Audit Clients*, highlights matters that you may wish to consider in establishing such policies and procedures. Also keep in mind the requirements of SAS No. 84, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 315). Note that you should not accept a new engagement until the required communications of SAS No. 84 have been evaluated. You may, however, make a proposal for the audit engagement prior to making those communications.

- *Assessing Independence*—Have you determined whether your firm is independent with respect to the entity to be audited? Again, consider SQCS No. 2 (QC sec. 20.14), which requires that "...policies and procedures should be established to provide the firm with reasonable assurance that personnel maintain independence (in fact and in appearance) in all required circumstances..." Remember, independence is required for *every* audit. The issue of independence is a complicated matter, far more complicated than some practitioners realize. A "gut-feeling" or "seat of the pants" approach will not suffice. See the "Independence" section of this Alert for a discussion of applicable standards and where you can get help in understanding how to apply them.
- *Engagement letters*—SAS No. 83, *Establishing an Understanding With the Client* (AICPA, *Professional Standards*, vol. 1, AU sec. 310.05), requires, as the name implies, that the auditor establish an understanding with the client regarding the services to be performed. That understanding should be documented in your working papers, preferably through a written communication with your client. Although this Standard does not mandate the use of engagement letters per se, most practitioners find

that their use helps all parties involved understand the needs and expectations of the others. Quite simply, it is viewed as good business practice.

- *Planning and Supervision*—A thorough understanding of the requirements of SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), will go a long way to developing an effective and efficient audit strategy. You may therefore wish to have your engagement staff review their understanding of this auditing Standard prior to the planning phase. Among the requirements of the SAS include the auditor's consideration of matters that relate to the entity's business, including those affecting the industry in which it operates, economic conditions, government regulations, and changes in technology. Many of these issues are addressed in the annual industry Audit Risk Alerts, which can be very helpful planning tools. A complete listing of this year's Alerts can be found in the "AICPA Industry Audit Risk Alerts" section herein. And don't underestimate the value of the Internet as a planning tool in learning about industry characteristics and developments. See appendix A of this Alert for a listing of Web sites that may be useful for this purpose.

- *Client Fraud/Illegal Acts*—Remember that the possibility of client fraud[3] and illegal acts should be considered during the planning phase of your audit. AU section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1), provides that "The auditor has a responsibility to *plan* [*emphasis added*] and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or *fraud* [*emphasis added*]." The auditor's responsibility to detect and report misstatements resulting from illegal acts having

3 See the "COSO's Fraud Report" section of this Alert for valuable insights into the issue of fraud.

a direct and material effect on the determination of financial statement amounts is the same as that for misstatements caused by error or fraud, as described in footnote 1 to AU section 110. Keep in mind that illegal acts, as defined by SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), *do not* include personal misconduct by the entity's personnel unrelated to their business activities.

- *Audit Risk and Materiality*—Audit risk is the risk that you will unknowingly fail to modify your audit opinion appropriately on financial statements that are materially misstated. With regard to materiality, financial statements are considered to be materially misstated if they contain misstatements whose effect is important enough to cause them not to be fairly presented in all material respects in conformity with generally accepted accounting principles (GAAP). SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312), requires auditors to consider audit risk and materiality when planning, as well when as performing the audit. Such consideration is necessary when, among other things, determining the nature and timing and extent of audit procedures, and in the evaluation of their results. In addition, the Securities and Exchange Commission (SEC) staff issued Staff Accounting Bulletin (SAB) No. 99, *Materiality*. A discussion of this new guidance appears later in this Alert.

- *Internal Control*—Remember that even if you adopt a substantive approach that places little or no reliance on the client's internal control, you still have responsibilities under SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended by SAS No. 78. In all audits you should obtain an understanding of internal control sufficient to plan the audit. After obtaining the understanding, you should assess control risk. Both the understanding and the basis for conclusions about the assessed level of control risk should be documented. In the planning phase, your understanding of the client's internal control should be used to identify types of potential misstatements, consider factors that affect the risk of material misstatement, and design substantive tests. The Audit Guide *Consideration of Internal Control in a Financial Statement Audit*, illustrates the application of SAS No. 55, as amended, using a practical and user-friendly approach.

- *Year 2000 Issue*—According to Interpretation No. 4, "Audit Considerations for the Year 2000 Issue," of AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 9311. 40), "The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement, whether caused by error or fraud. Thus the auditor's responsibility relates to the detection of material misstatements of the financial statements being audited, whether caused by the Year 2000 Issue or by some other cause." Refer to the "Year 2000 Issue" section of this Alert for further information.
- *Analytical Procedures*—Analytical procedures consist of the evaluation of financial information made by a study of relationships among both financial and nonfinancial data. SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1 AU sec. 329), requires their use in the planning, as well as in the overall review stages, of all audits. You will find that analytical procedures are extremely valuable in enhancing your understanding of the client's business and the transactions that occurred during the period and in identifying specific areas of risk. The Auditing Practice Release (APR) *Analytical Procedures* provides nonauthoritative guidance in the effective use of analytical procedures, including a series of questions and answers, plus an illustrative case study. The Internet can be a good source of benchmark data for use in analytical procedures. See appendix A of this Alert for a listing of Web sites that may be useful for this purpose.

Some other matters that might benefit from consideration in the planning phase include SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), and SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336). The AICPA *Audit and Accounting Manual* (Product No. 007259) contains a detailed and comprehensive presentation of issues relating to audit planning. Also included are sample planning checklists, engagement letters, and issues related to efficient engagement administration.

Executive Summary—Planning the Audit

- Planning is one of your primary concerns as an auditor this year and every year.
- Remember that the successful audit begins with successful planning.
- There are many pre-engagement and planning issues for you to consider—client acceptance, independence, establishing an understanding with the client, internal control, analytical procedures, and more.

Independence

When do you need to be independent? How do you determine whether or not you are independent? Is there help available for your independence questions?

Independence—sometimes referred to as the bedrock of the profession. The second general standard (AICPA, *Professional Standards*, vol. 1, AU sec. 150.02) of generally accepted auditing standards (GAAS) requires that, in all matters relating to the audit engagement, an independence in mental attitude is to be maintained by the auditor. SAS No.1 (AICPA, *Professional Standards*, vol. 1, AU sec. 220.03) provides that "To be independent, the auditor must *be* intellectually honest; to be *recognized* as independent, he must be free from any obligation to or interest in the client, its management, or its owners." Sounds fairly straightforward. However, making a determination as to whether one is actually independent or not can get complicated.

The issuance of the ISB's first standard, *Independence Discussions with Audit Committees* (see the "Independence and Other Ethics Standards" section of this Alert), serves as a good opportunity for us to review our understanding of independence issues. In assessing independence, it is useful to first address two issues:

1. Independence is a requirement, not just for the traditional audit, but for a number of different professional services covered by auditing and attestation standards. So we should first ask—*What type of professional service is being provided?*
2. Independence standards are promulgated by different standard-setting bodies. So we should next ask, *What are the applicable independence standards that must be complied with for this type of engagement?*

Type of Professional Service Provided

Why is the type of service to be performed a matter that must be considered? Well, quite simply, because not all professional services require independence under AICPA standards. Let's consider the following scenario and apply it to several different types of engagements.

> You are a partner in a CPA firm.[4] Your dependent daughter is the chief accounting officer for a small, privately held software development firm. She has just informed you that the firm is looking for a CPA to provide accounting services (these services would not involve the preparation or issuance of financial statements). Because of this family relationship, and the significant influence your daughter has over the company's accounting policies, you are not independent under AICPA rules with respect to this firm. Will your lack of inde-

[4] AICPA independence rules apply to individuals that fall within the definition of "a member or a member's firm" as defined in Ethics Interpretation 101-9, *The Meaning of Certain Independence Terminology and the Effect of Family Relationships on Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.11). Firm partners are always included in this definition. Therefore, a partner's lack of independence will extend to the entire firm. See Interpretation 101-9 with respect to other members of the firm.

pendence preclude you from performing this engagement? No. Why? Because professional standards do not require independence for this type of accounting service (See Ethics Interpretation 101-3, *Performance of Other Services* [AICPA, *Professional Standards*, vol. 2, ET sec. 101.05]).

- Let's alter this scenario just a bit. Assume that all the facts are the same, except that instead of seeking accounting services, the software development firm that employs your daughter needs audited financial statements for the purpose of obtaining a sizeable working capital loan. Can you audit this firm? No. You cannot perform the audit because your family relationship with a person having a position of significant influence within the entity impairs your independence. You must be independent to perform an audit.

- Now assume that the firm wishes to engage you only to perform certain agreed-upon procedures in connection with a proposed acquisition of another software development entity. Given the scenario noted above, can you provide this service? Again, the answer is no. SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* (AICPA, *Professional Standards*, vol. 1, AU sec. 622), requires the accountant to follow the second general standard (AU section 622.05). Accordingly, your lack of independence would preclude you from performing this engagement.[5]

- Let's alter the scenario again. Assume now that the firm needs only reviewed financial statements. Can you perform a review engagement for this entity? Sorry, again the answer is no. An accountant is precluded from issuing a review report on the financial statements of an entity with

[5] Note that there is an exception for a SAS No. 75 engagement, or an SSAE engagement where the report is *restricted*. In such situations, firm-wide independence is not required; however, the engagement team must be independent. (See Ethics Interpretation 101-11, *Independence and the Performance of Professional Services Under the Statements on Standards for Attestation Engagements and Statement on Auditing Standards No. 75*, Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement)

respect to which he or she is not independent (Statement on Standards for Accounting and Review Services [SSARS] No. 1, *Compilation and Review of Financial Statements* [AICPA, *Professional Standards*, vol. 2, AR sec. 100.38]). And what if the firm needed only compiled financial statements?[6] Because independence is not required for this service, the answer is yes, you could perform a compilation engagement for this entity. However, keep in mind that your compilation report must disclose, without description of the reason, your lack of independence (SSARS No. 1, AICPA, *Professional Standards*, vol. 2, AR sec. 100.22).

- What if the firm sought a CPA WebTrust Seal of assurance for its Web site? This new assurance service is considered to be an attest engagement. As such it must be conducted in accordance with Statement on Standards for Attestation Engagements (SSAE) No. 1, *Attestation Standards* (AICPA, *Professional Standards*, vol. 1, AT sec. 100), as amended by subsequent pronouncements. The fourth general standard of attestation provides that "In all matters relating to the engagement, an independence in mental attitude shall be maintained by the practitioner or practitioners." Therefore you may not perform this engagement if your independence is impaired. (Note that the Professional Ethics Executive Committee has a task force considering the "level" of independence that should be required for assurance services. Stay tuned.)

Help Desk—The AICPA's Web site includes a discussion of assurance independence concepts. Go to http://www.aicpa.org/assurance/scas/majtheme/indep/index.htm for further information.

So as you can see, the requirement for independence varies based on the nature of the service to be provided. Once you've determined that a particular service requires independence, you must then refer to the appropriate professional standards.

[6] Please refer to the AICPA *Compilation and Review Alert—1999/2000*, for a discussion of issues relating to compilations and reviews.

Applicable Independence Standards to Comply With

Independence and Privately Held Entities. If the engagement under consideration requires independence, what rules must be followed? The answer depends on whether the entity being audited is publicly or privately held.[7] If the professional service requiring independence is to be provided to a firm that is privately held, the applicable independence standards can be found in the AICPA's *Code of Professional Conduct* Rule 101—*Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101). Interpretations and Rulings under Rule 101 address a number of issues affecting independence, including direct or material indirect financial interests in an enterprise; joint, closely held business investments with an enterprise; loans to or from an enterprise; and many others.

Among some of the more common independence issues facing small practitioners and privately held entities are the following:

- *Providing a professional service requiring independence to a client for whom accounting services are also performed.* This may result in a situation that impairs independence. Consider the guidance set forth in Ethics Interpretation 101-3, *Performance of Other Services.*
- *Providing a professional service requiring independence to a client who has not paid fees for previously rendered services.* Past due fees may impair independence. This issue is addressed by Ethics Ruling No. 52, *Unpaid Fees* (AICPA, *Professional Standards*, vol. 2, ET sec. 191.103–.104).
- *Providing a professional service requiring independence to a client for whom services such as internal audit activities are provided.* See Ethics Interpretation 101-13, *Extended Audit Services* (AICPA, *Professional Standards*, vol. 2, ET 101.15) to assess the impact on independence.
- *Providing a professional service requiring independence to a client when certain family relationships exist.* Refer to Ethics

[7] Note also that some state societies, state accountancy boards, and regulatory agencies may have independence standards that must be considered.

Interpretation 101-9, *The Meaning of Certain Independence Terminology and the Effect of Family Relationships on Independence* (AICPA, *Professional Standards*, vol. 2, ET 101.11)

Help Desk—Assessing independence can be a complex and time-consuming undertaking. The AICPA can offer assistance. Call 1-888 777-7077 to speak to a member of our Professional Ethics team with your questions relating to AICPA independence standards. You may also submit your question in an email to ethics@aicpa.org.

Independence Issues and Publicly Held Entities. We've just considered independence standards as they relate to engagements involving privately held entities. However, if an entity is an SEC registrant, things get a bit more complicated. To assess the independence of auditors of publicly held entities, AICPA standards must be considered, along with standards set by the SEC and the ISB.

SEC auditor independence rules are set forth in rule 2-01 of SEC Regulation S-X, along with its interpretations, guidelines, and examples as collected in section 600 of the Codification of Financial Reporting Policies titled *Matters Relating to Independent Accountants.* The independence standards of the SEC and ISB[8] must be followed if, on a particular issue, they are either more restrictive[9] than those of the AICPA, or they address an issue with regard to which the AICPA Code of Professional Conduct is silent. If, on the other hand, the independence standards of the SEC and ISB are silent on a particular issue, or less restrictive (generally speaking this is unlikely), then the AICPA independence standards should be followed.

Help Desk—The ISB staff answers auditor independence inquiries (regarding auditors of public companies only) from

[8] The SEC recognizes the ISB as a standard-setting body that will establish and maintain a body of independence standards applicable to auditors of all SEC registrants, as discussed in Authorizing SEC Release (FRR-50).

[9] For example, AICPA rules provide that independence is not necessarily impaired if bookkeeping services are provided to a client. SEC rules view this situation as an impairment of independence.

practitioners, registrants, and other interested parties on both a formal and informal basis. Formal inquiries, which must be submitted in writing, result in written staff interpretations that can be relied upon by the requesting parties as being authoritative in dealing with the SEC. If and when the staff interpretations are ratified by the ISB Board, staff interpretations represent authoritative guidance for all registrants and their auditors. For further information, contact the ISB at (212) 596-6133 or visit their Web site at http://www. cpaindependence.org.

Executive Summary—Independence

- Independence—though in principle it may sound simple, determining whether you are independent can get tricky.
- In assessing independence you must determine if the engagement you are performing is one that requires independence. If so, you must then know what standards apply.
- For the audits of privately held entities, refer to the AICPA's independence standards. Also keep in mind that state societies, state boards, and regulatory agencies may also have independence standards that you must consider.
- For the audits of publicly held entities, AICPA, SEC, and ISB standards must be considered.
- Help is available. Contact the AICPA or the ISB for answers to your independence questions.

COSO's Fraud Research Report

What are some of the significant findings of the COSO fraud report? How can you benefit by understanding the report's findings?

In March 1999, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) released *Fraudulent Financial Reporting: 1987–1997, An Analysis of U.S. Public Companies*. This study provides an analysis of fraudulent financial reporting investigated by the SEC subsequent to the issuance of the 1987 *Report of the National Commission on Fraudulent Financial Reporting* (commonly known as the Treadway Commission report). COSO's stated intent in issuing its latest report is to foster a better understanding of the nature and causes of financial statement fraud, thus guiding future efforts to combat the problem.

This fascinating report examines incidents of fraudulent financial reporting alleged by the SEC in the Accounting and Auditing Enforcement Releases (AAERs) issued during the period between January 1987 and December 1997. Of the three hundred companies identified as being involved in alleged instances of fraudulent financial reporting, approximately two hundred companies were selected as a sample to be examined in detail.

The report provides some valuable insights into financial reporting fraud by identifying who commits the fraud, what kind of fraud is committed, and the implications to auditors. You may find these insights to be useful in helping to better understand, and fulfill, certain requirements of SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1 AU sec. 316). For example, armed with an understanding of the environment in which fraud is commonly perpetrated, the methods typically used to carry out fraud, and the financial statement accounts most often affected, you may find that you are better equipped to assess the risk of material misstatement due to fraud on the audit engagements you perform. To that end, we describe some of the significant findings of the report in the sections that follow.

> Help Desk—This following section presents only a summary of selected information from the study. It is highly recommended that the report be read in its entirety. The complete report, *Fraudulent Financial Reporting: 1987–1997, An Analysis of U.S. Public Companies* (Product No. 990036kk), can be obtained by calling the AICPA Order Department at 1-888-777-7077. The price is $20 for members.

The Nature of the Companies Involved

Were the entities involved in fraud generally larger or smaller companies? Entities engaging in financial statement fraud typically had assets well below $100 million—relatively small when compared to other public registrants. The majority of companies were not listed on the New York or American Stock Exchanges.

Were the entities involved in fraud concentrated in any particular industry? The industries affected most frequently included computer hardware and software (15 percent), other manufacturing (15 percent), financial services (14 percent), and healthcare or health products (11 percent).

Were the entities involved in fraud concentrated in any particular geographic location? Most of the frauds were committed at, or directed from, the companies' headquarter locations. The states with the highest concentration of sample companies were California (16 percent), New York (11 percent), and Florida (8 percent).

Did an entity's financial condition provide any incentives for fraudulent activities? For some entities, the pressures of financial strain may have been a factor. In the periods preceding the fraud, some companies were experiencing net losses or were in close to breakeven positions. In some cases, subsequent fraud may have been designed to reverse downward spirals; for others, fraud may have been perpetrated to sustain upward trends.

The Nature of the Control Environment

How often was upper management associated with the fraud? In eighty-three percent of the cases examined, the chief executive officer or chief financial officer was identified as being associated with the financial statement fraud. Other members of upper management named included the controller, chief operating officer, other senior vice presidents, and board members.

Where was the audit committee[10] *and the board of directors during the fraud?* One quarter of the companies had no audit committee. For those that did, most of the audit committees met only once a year. In addition, most audit committees appeared to be lacking in accounting or finance expertise. As for the boards,

[10] The *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees* addresses general concerns about the performance of audit committees. See "On the Horizon," later in this Alert.

approximately 60 percent of the directors had special ties to the company or its management. Nearly 40 percent had family relationships among the directors or the company's officers.

The Nature of the Fraud

Were the fraud amounts material when compared to the overall size of the company? Yes, the cumulative amounts of frauds were relatively large given the sizes of the companies involved. The average financial statement misstatement, or misappropriation of assets, was $25 million, while the average company had assets totaling $533 million.

Were most frauds limited to a single fiscal period? No. Most frauds overlapped at least two fiscal periods, often involving both quarterly and annual financial statements. The average fraud period had a duration of approximately two years.

What financial statement amounts were typically misstated? More than half of the frauds involved overstating revenues by recording them either fictitiously or prematurely. The remainder involved overstating assets by understating allowances for receivables; overstating the value of inventory, property, plant and equipment, and other tangible assets; and capitalizing items that should be expensed or recording assets that did not exist.

What methods were used to perpetrate revenue-related fraud? Some of the more common techniques for perpetrating revenue fraud included—

- Falsification of inventory records, shipping records, and invoices.
- Recording sales for goods shipped to other company locations.
- Recording sales after an order was placed, but before shipment to customers.
- Recognizing revenue for "conditional sales," that is, arrangements that contained unresolved contingencies or side agreements that altered the terms of the transaction.

- Recognizing sales that occurred in the subsequent accounting period (improper sales cutoff).
- Improper acceleration of the estimated percentage of completion for projects in process.
- Recognition of revenue for the shipment of goods not ordered, goods sent on consignment, or trial basis, or defective goods recorded at full, rather than discounted prices.

Help Desk—For a further discussion of improper revenue recognition and the related topic of earnings management, see *Audit Risk Alert 1998/99.* In addition, the AICPA publishes *Audit Issues in Revenue Recognition*, a valuable look at problematic revenue recognition issues discussed from the auditor's perspective. You may obtain this publication from the AICPA Web site at http://www.aicpa.org/members/div/auditstd/pubaud.htm.

Issues Related to the Outside Auditors

What types of audit reports were issued during the last year of the fraud period? Fifty-five percent of the opinions were unqualified. The remaining forty-five percent departed from the standard report because of issues relating to going concern, litigation, and other uncertainties, changes in accounting principles, and changes in auditors between fiscal years comparatively reported.

What size audit firms were typically associated with the misstated financial statements? Fifty-six percent of the companies were audited by a Big Eight or Big Six firm during the fraud period. Forty-four percent were audited by a non-Big Eight or Big Six firm.

Were the outside auditors implicated in financial statement fraud? In twenty-nine percent of the cases examined, the outside auditors were named for either alleged involvement in the fraud or for negligent auditing.

Did companies change auditors during the fraud period? Yes, some did. Just over twenty-five percent of the companies changed auditors. A majority of those changes occurred during the fraud period.

The report also suggests the relevant implications of these findings to senior management, the board of directors, the audit committee, and outside auditors. The significant recommendations relevant to auditors[11] include—

- The need for the effective monitoring of an entity's going concern status.
- The importance of effective communications with predecessor auditors.
- The importance of understanding the entity's control environment.
- The effective consideration and testing of internal control related to transaction cutoff and asset valuation (based on the assessment of control risk).
- The need for the auditor to look beyond the financial statements to understand the risks unique to the client's industry[12], management's motivation toward aggressive reporting, and client internal control.
- The potential for greater risk when auditing entities with weak board and audit committee governance.

The details of these recommendations can be found in the complete version of the report.

[11] With regard to these recommendations, auditors should refer to the requirements of the professional literature, including SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341); SAS No. 84, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 315); SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (as amended by SAS No. 78) (AICPA, *Professional Standards*, vol. 1, AU sec. 319); and SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316).

[12] A number of this year's industry-specific Audit Risk Alerts will address SAS No. 82 and discuss fraud risk factors that are unique to the industry. A listing of industry Alerts can be found in the "Guides and Audit Risk Alerts" section herein.

Executive Summary—COSO's Fraud Research Report

- The COSO fraud report is a fascinating, insightful analysis of incidents of fraudulent financial reporting investigated by the SEC.
- The report discusses the nature of the companies involved in fraud, the nature of the control environment, the nature of the fraud, issues related to auditors, and other matters.
- You may find the report's insights to be useful in helping to better understand, and fulfill, certain requirements of SAS No. 82.

Fraud—A Closer Look

What is the auditor's responsibility to detect fraud in a financial statement audit?

The COSO fraud report and recent highly publicized instances of fraudulent financial reporting serve as reminders to auditors of the need to remain alert to possible instances of fraudulent activity and to maintain an appropriate attitude of professional skepticism. A number of prominent fraud cases reported have involved either management fraud or deliberate deceit by management in working with their auditors. Some of the more common audit issues identified in recent litigation related to fraudulent financial reporting included—

- A willingness by the auditor to accept management's representations without corroboration.
- Allowing the client to unduly influence the scope of auditing procedures.
- The failure to identify risky situations, or ignoring identified audit risks by not applying professional skepticism and revising auditing procedures appropriately.

Auditors are not responsible for detecting fraud *per se*; however, auditors do have a responsibility to plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement, whether caused by error or fraud. The issuance of SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), did not change the auditor's responsibility with respect to fraud, but was designed to help auditors to fulfill their responsibility to detect material misstatements of financial statements caused by fraud.

Among other things, the Standard—

- Describes the characteristics of fraud. The more the auditor knows about the nature of fraud, the better he or she will be equipped to identify risk factors, assess the risk of material misstatement due to fraud, and develop an appropriate audit response.
- Requires the auditor to make an assessment as to the risk of material misstatement due to fraud, from the perspective of the broad categories listed in the SAS. The assessment is separate from, but may be performed in conjunction with, other risk assessments made during the audit. The SAS also requires the auditor to reevaluate the assessment if other conditions are identified during the field work.
- Provides examples of fraud risk factors that, when present, might indicate the presence of fraud.
- Requires the auditor to document evidence of the performance of the fraud risk assessment, including risk factors identified as being present and the auditor's response to those risk factors.
- Requires the auditor to communicate to management at the appropriate level and, in certain circumstances, directly with the audit committee.

The presence of a fraud risk factor, or even many fraud risk factors, does not always mean that there has been a fraud. But it may indicate the presence of a fraud. The examples of fraud risk factors in the SAS were developed from research on known frauds, and have often been observed in circumstances involving fraud.

Consider the example where an auditor, in the planning phase of the audit, becomes aware that the client was having cash flow problems in spite of reported profits and earnings growth, and was operating in a declining industry with increasing business failures and significant declines in customer demand. The auditor ordinarily would use this information to identify high-risk audit areas while planning the audit. The auditor also should be aware that these items are fraud risk factors. Because of this, the auditor should consider this information as an indicator of possible fraud and plan and perform the auditing procedures accordingly.

The assessment of the risk of a material misstatement due to fraud is a cumulative process. Over the course of the audit, the auditor may become aware of the presence of additional risk factors. For example, the auditor may learn that—

- Management is dominated by a small group of individuals, who could probably override any internal controls.
- There are significant pressures to obtain additional capital to remain competitive.
- Management has committed to analysts to achieve what appear to be unduly aggressive or unrealistic financial targets.

The auditor may also uncover, during the audit, unusual journal entries to the accounts receivable ledger or sales journal that significantly affect reported earnings, or a significant number of pre- or post-dated transactions.

Regardless of when the auditor discovers fraud risk factors or other conditions related to the fraud risk assessment, the auditor should consider their effect on auditing procedures. The auditor should document the risk factors identified, as well as the auditor's response to the risk factors. The fraud risk factors and other conditions identified may cause the auditor to believe that the planned audit procedures are not sufficient to provide reasonable assurance that the financial statements are free from material misstatement. Accordingly, auditing procedures should be planned and performed to specifically address the identified risks.

In certain situations, management may have the motive (pressure to obtain additional capital) and opportunity (ability to override internal controls) to improperly recognize revenue, perhaps by recording fictitious sales or recognizing revenue in the improper period. In such circumstances, the auditor may consider expanding audit procedures in this area by—

- Thoroughly examining original (not copies) source documents.
- Analyzing credit memos and other accounts receivable adjustments.
- As part of the confirmation process, confirming the terms of sale with customers, including the existence of side-agreements.
- Analyzing large or unusual sales made prior to the period end.
- Scanning the general ledger, sales journal, and accounts receivable sub-ledger for unusual activity.
- Comparing operating cash flows to sales by sales person, location, or product.

Above all, auditors must maintain an appropriate attitude of professional skepticism. This means neither assuming that management is dishonest nor assuming unquestioned honesty; obtaining corroborating evidence for management representations; considering whether misstatements may be the result of fraud; and appropriately designing and performing auditing procedures to address fraud risk factors. The application of professional skepticism in response to the auditor's assessment of the risk of material misstatement due to fraud might include (1) increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions, and (2) increased recognition of the need to corroborate management explanations or representations concerning material matters—such as further analytical procedures, examination of documentation, or discussions with others within our outside the entity.

Help Desk—For further information on fraud refer to the self-study course, *Consideration of Fraud in a Financial Statement Audit: The Auditor's Responsibilities under SAS No. 82* (Product no. 732045kk) and the AICPA Practice Aid, *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82* (Product no. 008883kk), which walks the practitioner through the issues likely to be encountered in applying the SAS to audits and provides valuable tools, such as sample documentation. It also provides specific guidance on applying the concepts of the SAS to several industries.

The Year 2000 Issue

What is the Year 2000 Issue? How will it affect your audits?

By now, you are aware of the Year 2000 Issue and its potential to adversely affect the operations of entities that rely, directly or indirectly, on information technology. But, as auditor, what are your responsibilities for the Year 2000 Issue?

First, it must be understood that it is the responsibility of an entity's management—not the auditor's—to assess and remediate the effects of the Year 2000 Issue on the entity's systems. The Year 2000 Issue does not create additional responsibilities for the auditor. Under GAAS, the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Thus, the auditor's responsibility relates to the detection of material misstatement of the financial statements being audited, whether caused by the Year 2000 Issue or by some other cause.

Auditing Guidance

As we approach the end of 1999, some organizations may intend to modify their normal business practices (for example, suspending operations around December 31, 1999) or financial accounting procedures (for example, modifying previous procedures for closing the general ledger and preparing quarterly or annual financial statements as of December 31, 1999.) Organizations also may experience significant changes in historical patterns of sales or purchases because of uncertainties about the Year 2000 readiness among trading partners. As part of the audit planning process, auditors may wish to specifically inquire about any changes their client anticipates in such items that might have an effect on the audit (for example, timing of sales cut-off procedures, timing of inventory observations), and consider the possible effect such items may have on the nature, timing and extent of planned audit procedures (for example, historical analytical relationships may be different because of changes in normal business practices). Auditors also should anticipate that changes in normal business practices may also represent additional accounting or disclosure issues that may not be identified until year end, such as considering whether an unusually high level of December 1999 sales will be accompanied by an unusually high level of January returns, and consequently whether the reserve for returns is adequate.

Auditors also should consider whether any year-2000-related events have occurred subsequent to the balance-sheet date but prior to the issuance of the financial statements and the auditor's report that require adjustment or disclosure in the financial statements. Examples of such events and how companies should account for them are discussed in EITF Issue No. 99-11, *Subsequent Events Caused by Year 2000* (see discussion below under "Accounting Considerations").

Auditing guidance relating to the Year 2000 Issue has also been developed by the Audit Issues Task Force (AITF) of the Auditing Standards Board (ASB). The AITF has issued the following auditing Interpretations.

- Interpretation No. 4, "Audit Considerations for the Year 2000 Issue," of AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 9311.38), discusses the auditor's responsibility for the Year 2000 Issue, how it affects planning for an audit of financial statements conducted in accordance with GAAS, and under what circumstances the Year 2000 Issue may result in a reportable condition under SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325).

- Interpretation No. 3, "Responsibilities of Service Organizations and Service Auditors With Respect to Information About the Year 2000 Issue in a Service Organization's Description of Controls," of SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 9324.19), clarifies the responsibilities of service organizations and service auditors for information about the Year 2000 Issue in a service organization's description of controls. This Interpretation is being amended to further clarify a service auditor's responsibility with respect to design deficiencies that the service auditor becomes aware of that did not affect processing during the period covered by the service auditor's examination, but did result in incorrect processing during the subsequent events period and could affect user organizations. The amended Interpretation is expected to be available on the AICPA Web site in November 1999. A brief summary of the Interpretation being considered at the time we went to press is included in the New Auditing Pronouncements section.
- Interpretation No. 2, "Effect of the Year 2000 Issue on the Auditor's Consideration of an Entity's Ability to Continue as a Going Concern", of SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 9341.03), provides guidance regarding the identification and evaluation of conditions and events of the kind identified in SAS No. 59 that relate to the Year 2000 Issue.

In addition, the AITF issued attestation Interpretation No. 1, "Consideration of the Year 2000 Issue When Examining or Reviewing Management's Discussion and Analysis", of SSAE No. 8, *Management's Discussion and Analysis* (AICPA, *Professional Standards*, vol. 1, AT sec. 9700.01), which provides guidance on the practitioner's responsibility with respect to year 2000 disclosures.

Engagement Letters

Auditors may wish to specifically address the Year 2000 Issue in connection with obtaining an understanding with their client, pursuant to SAS No. 83, *Establishing an Understanding With the Client* (AICPA, *Professional Standards,* AU sec. 310). SAS No. 83 requires auditors to obtain an understanding with the client about the service to be performed, including the objectives and limitations of an audit of financial statements. With regard to the Year 2000 Issue, auditors may wish to consider adding language such as the following to their engagement letter:

> Because many computerized systems use only two digits to record the year in date fields (for example, the year 1999 is recorded as 99), such systems may not be able to process dates accurately in the year 2000 and after. The effects of this problem vary from system to system and may adversely affect an entity's operations as well as its ability to prepare financial statements.
>
> An audit of financial statements conducted in accordance with generally accepted auditing standards is not designed to detect whether the entity's systems are year 2000 ready. Further, we have no responsibility with regard to the Company's efforts to make its systems, or any other systems such as those of the Company's vendors, service providers, or any other third parties, year 2000 ready or provide assurance on whether the Company has addressed or will be able to address all of the affected systems on a timely basis. These are responsibilities of the Company's management. However, for the benefit of management, we may choose to communicate matters that come to our attention relating to the Year 2000 Issue.

Management Letters

The auditor also may wish to consider whether year-2000-related problems should be highlighted in his or her management comment letters. Through inquiries of client personnel, the auditor may obtain information regarding the client's understanding of the Year 2000 Issue and, if applicable, the progress of its year 2000 project efforts. The auditor may wish to communicate to senior management and the audit committee the results of such inquiries and any observations regarding the year 2000. However, auditors should be cautious in these communications not to imply an assumption of assuring year 2000 readiness.

Depending on the entity's reliance on date-dependent processing and the state of preparedness for the year 2000, the auditor also may want to address certain other situations relating to the Year 2000 Issue in his or her management letter. Situations such as the following may occur.

- The client has not begun to address the Year 2000 Issue. The client recognizes the issue but needs to develop a year 2000 project plan.
- The client recognizes the issue but needs to assess the effect of the year 2000 issue on its systems.
- The client needs to consider the budget and resource implications of the plan.
- The client is not currently meeting its year 2000 project plan timetables.

Accounting Considerations

Auditors should also be alert to the numerous accounting considerations that arise out of the Year 2000 Issue. As this publication went to press, the FASB's Emerging Issues Task Force (EITF) was discussing but had not reached a consensus on Issue No. 99-11, *Subsequent Events Caused by Year 2000*. The issue is when costs or losses associated with Year 2000 failures that are detected subsequent to the balance sheet date but prior to the issuance of financial statements should be recognized. The Issue provides several cases to illustrate how various transactions could be affected by Year 2000 failures. The types of transactions include warranty, receivables from product sales, loans, inventory, capitalized software costs, long-lived assets, contracts to provide services, litigation for lost profit or loss of business, insurance policies, and sales with the right of return. Auditors may wish to visit the FASB Web site at http://www.fasb.org to monitor the status of this guidance.

Auditors should consider whether the costs associated with their client's modifications of computer systems pursuant to the Year 2000 Issue have been properly accounted for. The EITF has considered this matter in Issue No. 96-14, *Accounting for the Costs Associated with Modifying Computer Software for the Year 2000.* This EITF Issue addresses accounting for the external and internal costs specifically associated with the modification of internal-use computer software for the year 2000. The issue does not address purchases of hardware or software that replace existing software that is not year-2000-ready, nor does it address impairment or amortization issues relating to existing assets. The task force reached a consensus that external and internal costs specifically associated with modifying internal-use software for the year 2000 should be charged to expense as incurred. In addition, EITF Issue No. 97-13, *Accounting for Costs Incurred in Connection with a Consulting Contract or an Internal Project That Combines Business Process Reengineering and Information Technology Transformation*, provides relevant guidance when an entity's year 2000 project involves business process reengineering.

The Year 2000 Issue may render certain client assets (such as computer hardware and software) obsolete or inoperable. Accordingly, auditors may wish to consider whether the client has properly accounted for such events by appropriately adjusting useful lives, residual values, or both, or recognizing impairment losses pursuant to the guidelines set forth under Financial Accounting Standards Board (FASB) Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of.*

Other accounting issues that may arise include the following:

- Revenue recognition principles for software transactions are set forth in AICPA Statement of Position (SOP) 97-2, *Software Revenue Recognition*, as amended by SOP 98-9, *Modification of SOP 97-2,* Software Revenue Recognition, *With Respect to Certain Transactions.* This SOP provides guidance on the amount and timing of revenue recognition in arrangements that may include the presence of specific factors, including uncertainty of customer acceptance; customer cancellation privileges; and multiple elements, including upgrades and enhancements and postcontract customer support. Entities should be aware that the Year 2000 Issue could affect one or more of these factors and have an unexpected effect on future revenue recognition.

- The Year 2000 Issue may create product warranty and product defect liability and product returns issues for software and hardware vendors. These vendors should consider FASB Statement No. 5, *Accounting for Contingencies*, paragraphs 24 to 26, if there are product warranty or product defect liability issues and FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*, for product return issues.

- Software developers should evaluate arrangements to address the Year 2000 Issue performed for other entities for a fee that are being accounted for under SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*. For any contract expected to result in a loss, the vendor should record a provision for the entire loss in the period in which it becomes evident.

- FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*, is the authoritative standard on accounting for costs incurred to produce or purchase software that is to be sold, leased, or otherwise marketed. Only certain costs qualify for capitalization under this standard. In accordance with the guidance in the Statement, a write-down or an acceleration of amortization may be necessary if estimated future gross sales are lower than expected because of the Year 2000 Issue.

- Inventories of hardware devices that are not year-2000-ready would be subject to the lower of cost or market test described in Accounting Research Bulletin (ARB)

43, *Restatement and Revision of Accounting Research Bulletins*, chapter 4, paragraph 8.

- In addition to the disclosure requirements under the pronouncements previously mentioned, practitioners should be aware of the requirements of SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. Although the need for disclosure by an entity depends on facts and circumstances, disclosure may be required in areas such as impairment or amortization of capitalized software costs, inventory valuation, long-term contract accounting, or litigation if it is reasonably possible that the amounts reported in the financial statements could change by a material amount within one year from the date of the financial statements. Disclosures also may be required of current vulnerability due to certain concentrations if, for example, a significant vendor has not satisfactorily addressed the Year 2000 Issue.

SEC Disclosure Requirement

Auditors of publicly held companies should consider the guidance set forth by the SEC in its Interpretation "Statement of the Commission Regarding Disclosure of Year 2000 Issues and Consequences by Public Companies, Investment Advisers, Investment Companies, and Municipal Securities Issuers" (the SEC Interpretation). The SEC Interpretation—

- Provides guidance to public companies so they can determine whether their Year 2000 Issues are known material events, trends, or uncertainties that should be disclosed in the Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) section of their disclosure documents.
- Sets forth SEC guidance regarding specific matters for companies to address in their MD&A Year 2000 Issue disclosure.
- Addresses the need for companies to consider the Year 2000 Issue in connection with other rules and regulations and when they prepare financial statements.

- Reminds registrants that the antifraud provisions of the federal securities laws apply to disclosure about the Year 2000 Issue.

Help Desk—The SEC Interpretation supersedes the guidance previously set forth in the revised Staff Legal Bulletin No. 5. The full text of the Interpretation can be viewed on the SEC Web site http://www.sec.gov/news/home2000.htm.

The Litigation Risk

Auditors should also be aware of the risk of litigation relating to the Year 2000 Issue. Some clients may be uninformed about the Year 2000 Issue, while others may underestimate its magnitude. Those who mistakenly believe that the Year 2000 Issue should be addressed and resolved as part of the audit process may seek legal recourse if that outcome is not achieved. Therefore, auditors may wish to educate their clients on the Year 2000 Issue and its implications. As previously discussed, auditors may wish to incorporate these issues in the engagement letter by outlining the responsibilities of both the client and the auditor. By advising the client and planning ahead, auditors may avoid any potential dispute with the client, while at the same time offering the opportunity of helping the client understand the seriousness of the problem and identifying resources that may be needed to address the issues.

Help Desk—A bill (the Y2K Act) limiting the liability of companies and individuals for computer breakdowns caused by the Year 2000 Issue was signed into law on July 20, 1999. Search for the Y2K Act on the Internet Web site—Thomas, Legislative Information on the Internet, at http://thomas.loc.gov.

More on the Year 2000 Issue

A more comprehensive discussion of the numerous auditing and accounting issues related to the Year 2000 Issue is presented in the AICPA publication *The Year 2000 Issue—Current Accounting and Auditing Guidance.*[13] The publication provides a wealth of information for auditors, including discussions relating to the following:

- Introduction to and implication of the Year 2000 Issue
- Industry specific considerations
- Financial reporting issues
- Auditing issues
- Disclosure considerations
- Auditor communications
- Practice management issues

Help Desk—This document can be obtained, free of charge, at the AICPA's Web site at http://www.aicpa.org/members/y2000/intro.htm. The AICPA Web site provides a year 2000 resource page with links to many useful sites as well.

Additional information relating to the year 2000 issue is also available on the Internet at the following Web sites:

- The National Bulletin Board for the Year 2000—at http://www.year2000.com
- Management Support Technology at http://www.mstnet.com/year2000
- AICPA, Links to Other Sources—http://www.aicpa.org/members/y2000/sources.htm

In addition, the AICPA publication *Accounting Trends and Techniques—1999* (Product No. 009890kk), contains examples of Year 2000 Issue financial statement disclosures made by publicly held entities.

[13] With regard to this publication, the SEC Interpretation on year 2000 issues states that "Although the term may is used throughout the AICPA's guidance, perhaps suggesting that the guidance is discretionary, we believe that the procedures outlined by the AICPA should be considered appropriate practice at this time and we expect companies and their auditors to comply with that guidance. If they do not, they should be prepared to justify why the procedures were not followed."

Executive Summary—The Year 2000 Issue

- Unless corrective actions are taken, the year 2000 may cause accounting and financial information systems to produce inaccurate date-related output.
- The AITF has issued Interpretations providing guidance to auditors on the Year 2000 Issue.
- Auditors may wish to include references to the Year 2000 Issue in their engagement and management letters.
- Auditors should consider guidance on client accounting being developed by the EITF in Issue No. 99-11, *Subsequent Events Caused by Year 2000.*
- Auditors should consider client accounting for the Year 2000 Issue pursuant to such pronouncements as EITF Issue No. 96-14; SOP Nos. 81-1, 94-6, and 97-2; ARB 43; and FASB Statement Nos. 5, 48, 86, and 121. For publicly held entities, SEC rules and regulations should be considered.
- Auditors should be alert to the litigation threats that may arise from the Year 2000 Issue.

Materiality—SEC Staff Bulletin

What does the new SEC Staff Accounting Bulletin have to say about materiality? What effect will it have on financial statement preparation and audits?

The SEC staff has released SAB No. 99.[14] This SAB addresses the application of materiality thresholds to the preparation and audit of financial statements filed with the SEC. The SAB states that it does not create new standards or definitions for materiality, but reaffirms the concepts of materiality as expressed in the accounting and auditing literature as well as in long-standing case law.

[14] SABs are not rules or interpretations of the SEC; they represent interpretations and practices followed by staff of the Office of the Chief Accountant and the Division of Corporation Finance in administering the disclosure requirements of the federal securities laws.

Indeed, the SAB draws heavily on the existing auditing and accounting literature on materiality, and makes some important statements. These statements include the following:

- Registrants and auditors may not rely solely on a numerical threshold to determine what is material.
- The materiality of misstatements discovered in the financial reporting and auditing processes must be considered both individually and in the aggregate.
- Intentional misstatements that are not material are inappropriate and may be unlawful.

The SAB addresses the evaluation of misstatements discovered in the financial reporting and auditing processes, and does not affect the auditor's consideration of materiality in planning the audit.

Qualitative Characteristics of Materiality

Registrants and the auditors of their financial statements should not rely exclusively on quantitative benchmarks, or rules of thumb, to determine whether an item is material to the financial statements. A numerical threshold may provide the basis for a preliminary assumption that an amount is unlikely to be material; however, it is not a substitute for a full analysis. The accounting literature reminds us that an amount is material if the "magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the [financial] report would have been changed or influenced by the inclusion or correction of the item."[15] Thus, management and auditors must consider both quantitative and qualitative aspects of unadjusted differences and omissions.

SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312), provides auditors with guidance on evaluating audit findings (see AU sec. 312.35–.40). SAS No. 58, *Reports on Audited Financial*

[15] FASB, Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information.*

Statements, also provides guidance on evaluating the materiality of departures from generally accepted accounting principles (see AICPA, *Professional Standards*, vol. 1, AU sec. 508.36). SAB No. 99 provides some additional qualitative factors to consider and states that among the considerations that may well render material a quantitatively small misstatement of a financial statement item are whether the misstatement—

- Arises from an item capable of precise measurement or whether it arises from an estimate and, if the latter, the degree of imprecision inherent in the estimate.
- Masks a change in earnings or other trends.
- Hides a failure to meet analysts' consensus expectations for the enterprise.
- Changes a loss into income or vice versa.
- Concerns a segment or other portion of the registrant's business that has been identified as playing a significant role in the registrant's operations or profitability.
- Affects the registrant's compliance with regulatory requirements.
- Affects the registrant's compliance with loan covenants or other contractual requirements.
- Has the effect of increasing management's compensation—for example, by satisfying requirements for the award of bonuses or other forms of incentive compensation.
- Involves concealment of an unlawful transaction.

SAB No. 99 also emphasizes the possible effect of misstatements on segment disclosures. For example, it states that a misstatement of the revenue and operating profit of a relatively small segment that is represented by management to be important to the future profitability of the entity is more likely to be material to investors than a misstatement in a segment that management has not identified as especially important.

Auditors and management may wish to consider expanding their documentation of the reasons for concluding that unadjusted misstatements are not material to include salient qualitative considerations.

Aggregation of Unadjusted Differences

SAB No. 99 reminds auditors that, when evaluating the materiality of unadjusted differences, they should be considered both individually and in the aggregate. An individually material misstatement should not be aggregated with offsetting immaterial amounts as part of an analysis that justifies that, as a whole, the misstatements are not material. In addition, SAS No. 47 states that "the auditor should aggregate misstatements that the entity has not corrected in a way that enables him or her to consider whether, in relation to individual amounts, subtotals, or totals in the financial statements, they materially misstate the financial statements taken as a whole." (See AU sec. 312.34.) Also, the SEC staff believes that, in considering the aggregate effect of multiple misstatements on a subtotal or total, registrants and the auditors of their financial statements should exercise particular care when considering whether to offset (or the appropriateness of offsetting) a misstatement of an estimated amount with a misstatement of an item capable of precise measurement.

Intentional Misstatements

SAB No. 99 states that management should not make intentional immaterial errors in a registrant's financial statements to "manage" earnings, and that, in certain circumstances, intentional immaterial misstatements are unlawful. The SAB makes some subtle observations about management's intent and the legality of intentional misstatements, some of which are discussed below. It further reminds registrants of their legal responsibility to keep books, records, and accounts that, in reasonable detail, accurately and fairly reflect transactions and the disposition of assets. The SAB also reminds auditors of their obligation to inform management and, in some cases, the audit committee of illegal acts that come to the auditor's attention.

The SEC staff believes that a registrant and the auditors of its financial statements should not assume that even small intentional misstatements in financial statements are immaterial. While the intent of management does not render a misstatement material, it may provide significant evidence of materiality. The evidence may be particularly compelling where management has intentionally misstated items in the financial statements to "manage" reported earnings. In that instance, management presumably has done so believing that the resulting amounts and trends would be significant to users of the registrant's financial statements. The SEC staff believes that investors generally would regard such a practice as significant.

In discussing the legality of misstatements, SAB No. 99 focuses on intent. The SAB states that it is unlikely that it is ever "reasonable" for registrants to record immaterial misstatements *or not to correct known immaterial misstatements* as part of an ongoing effort directed by or known to senior management for the purposes of "managing" earnings. Therefore, when evaluating the materiality of unadjusted misstatements, it becomes important to consider factors such as analysts' consensus estimates and other factors that might be motivating management.

The SAB reminds auditors of their responsibilities under GAAS and the securities laws to report illegal acts to management and, under certain circumstances, to the audit committee. However, it does not provide any definitive conclusions about when an immaterial misstatement is an illegal act. If the auditor identifies otherwise immaterial misstatements that he or she suspects are either intentional or were not corrected "as part of an ongoing effort directed by or known to senior management for the purposes of managing earnings," he or she may need to consider consulting with legal counsel.

Registrants and their auditors are urged to read the SAB fully and carefully. The ASB has established a task force to consider whether the auditing standards should be amended or interpreted, or whether additional guidance is needed.

Help Desk—The full text of the SAB can be viewed at the SEC Web site http://www.sec.gov/rules/acctreps/sab99.htm. Additional sources of guidance on materiality evaluation include Practice Alert 94-1, *Dealing With Audit Differences*, issued by the Professional Issues Task Force (PITF) of the AICPA SEC Practice Section Executive Committee (the Alert is available on the AICPA's Web site at http://www.aicpa.org) and a "White Paper" on materiality developed by a task force of the five largest accounting firms (this paper also is available on the AICPA's Web site).

Peer Review—Common Engagement Deficiencies

What are some of the common engagement deficiencies cited in peer reviews?

In this section we present a selection of significant and recurring engagement deficiencies commonly noted in peer reviews of CPA firms with non-SEC registrant clients. Significant deficiencies are those that are considered to be material to understanding the report or financial statements, or that represent critical auditing procedures. Engagements with significant deficiencies are generally considered to be substandard.

Deficiencies noted in audit procedures and documentation include—

- Failure to assess the risk of fraud (as required by SAS No. 82).
- Failure to document the auditor's consideration of internal control (as required by SAS No. 55, as amended).
- Failure to use a written audit program (as required by SAS No. 22).
- Failure to obtain legal representation letter if an attorney was consulted (as required by SAS No. 12).
- Failure to obtain a management representation letter (as required by SAS No.84).

Deficiencies noted in audit reporting (SAS No. 26, 58) include—

- Issuance of an audit report when the auditor is not independent.
- Departures from standard wording where the report does not contain the critical elements of applicable standards.
- Failure to appropriately qualify the audit report for a scope limitation or departure from the basis of accounting used for the financial statements.
- Failure to disclose a material departure from GAAP in the audit report.
- Failure to issue reports on compliance or internal control for audits subject to Government Auditing Standards.

Audit Sampling

What are some of issues to be considered in audit sampling? Where can you obtain practical guidance for sampling?

GAAS does not require auditors to use sampling. Yet it goes without saying that few audits involve the examination of every transaction that occurred within the period under consideration. Indeed, in most situations testing every item that could possibly be selected for examination would make a timely and reasonably priced audit virtually impossible. Instead it is far more common for auditors to examine something less than an entire population or class or items. But is "something less than the entire population" always considered to be a sample for the purposes of SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350)?

SAS No. 39 defines sampling as "...the application of an audit procedure to less than 100 percent of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class..." It is important to keep in mind, therefore, that merely testing less than 100 percent of a given population does not constitute sampling as defined by SAS No. 39. The audit test must be performed for the purpose of evaluating some characteristic of the entire balance or class in order to meet that definition.

Let's assume that you have decided to test less than 100 percent of a particular account. You have chosen to audit only those items above a predetermined dollar amount, and to do nothing more. In this situation, SAS No. 39 would not apply. Yes, you have audited less than 100 percent of the population, but you have not projected test results to the population as a whole. Instead, you have tested 100 percent of the items in a particular subpopulation—those above the predetermined dollar amount. In this circumstance, it is not appropriate to project the results of that test to the remaining balances, because those remaining balances had no opportunity to be selected for testing. Examples of other procedures that, in general, do not involve sampling include inquiry and observation, analytical procedures, and procedures applied to every item in a population.

Sampling is a complex area. The issue of what does or does not constitute sampling is just one of a number of matters for auditors to consider. Some of the key requirements of SAS No. 39 to keep in mind are as follows:

- *Sample selection*—Select sample items in such a way that they can be expected to be representative of the population from which they are drawn. All items in the population should have an opportunity to be selected.
- *Evaluation*—Misstatements detected in a sample for a substantive test of details should be projected to the population, thus yielding an estimate of the total projected misstatement in the population. Be sure to consider the nature and cause of the misstatements and their possible relationship to other phases of the audit as well.
- *Sampling risk*—Consider the risk that the conclusions reached on the basis of tests applied to a sample might be different from those that would have been reached if the test were applied in the same way to the entire population. In other words, a sample may contain more, or less, monetary misstatements, or deviations from prescribed

controls, than exist in the balance or class as a whole. Note that sampling risk is inversely related to sample size. With all other factors remaining the same, the larger the sample, the lower the sampling risk.

- *Tolerable misstatement*—When using sampling in substantive tests of details, this is how much monetary misstatement in the related account balance or class of transactions may exist without causing the financial statements to be materially misstated. When using sampling in tests of controls, this is the maximum rate of deviation from the prescribed control that you would be willing to accept without altering your planned assessed level of control risk.

The AICPA has recently issued an Auditing Practice Release (APR) titled *Audit Sampling* (Product No. 021061kk). This APR, which supersedes the Audit Guide *Audit Sampling*, provides guidance to help auditors apply audit sampling in accordance with SAS No. 39. It provides practical guidance on the use of both nonstatistical and statistical sampling in auditing. You can use the APR as a reference source if you are knowledgeable about audit sampling. Or, if you are new to this area, you can use the APR as an initial introduction to sampling. Some of the topics that the APR addresses include sampling vs. nonsampling techniques, statistical and nonstatistical sampling, determining sampling size, controlling sample risk, evaluating sample results, sampling in tests of controls, and sampling in substantive tests of details.

Audit Committees

What should you know about communications with audit committees?

With the release of the *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees* (See "On the Horizon" later in this Alert), the issuance of Independence Standard No. 1, *Independence Discussions with Audit Committees* (see "Independence and Other Ethics Standards" later in this Alert), and the COSO fraud report discussion of the problem of weak audit committee and board governance, the topic of audit committees has been a prominent one this year. This provides us with a good opportunity to review the auditor's obligations with respect to audit committee communications.

SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), requires auditors to communicate certain matters to those who have responsibility for the oversight of the financial reporting process. For the purposes of this Standard, the recipient of the communications is referred to as the audit committee. The auditor is required to make these communications only in audits of—

1. Entities that either have an audit committee or that have otherwise formally designated oversight of the financial reporting process to a group equivalent to an audit committee.
2. All SEC engagements (this term is specifically defined by SAS No. 61 in footnote 2 of AU section 380.01).

SAS No. 61 requires the following matters to be communicated:

- The auditor's responsibility under GAAS
- Significant accounting policies
- Management judgments and accounting estimates
- Significant audit adjustments
- The auditor's responsibility for other information in documents containing audited financial statements, any procedures performed on the information, and the results
- Disagreements with management
- Consultation with other accountants
- Major issues discussed with management prior to retention.
- Difficulties encountered in performing the audit

The communications required may be in oral or written form (sample illustrative communications with audit committees can be found in the AICPA *Audit and Accounting Manual*, Product No. 007259kk). If the communications are oral, the auditor should document the communications by appropriate memoranda or notations in the working papers. If those matters required to be communicated do not apply to a particular engagement, then documentation is not necessary because no communication was required.

Note that in audits of most nonpublic smaller companies that have only a board of directors, the auditor may, but is not required to, make these communications. Note also that other auditing Standards address communications with the audit committee, including—

- SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325). The auditor is required to report to the audit committee all reportable conditions. Reportable conditions, which include material weaknesses in internal control, are matters coming to the auditor's attention that, in his or her judgment, should be communicated to the audit committee because they represent significant deficiencies in the design or operation of internal control, which could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.
- SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316). Whenever the auditor has determined that there is evidence that fraud may exist, the auditor is required to bring this matter to the attention of management, the audit committee or others. To whom the auditor reports depends on the nature of the possible fraud and who is involved. For example, fraud involving senior management, even if it did not result in a material misstatement of the financial statements, should be reported directly to the audit committee. The auditor's responsibility also depends on whether the entity is an SEC

registrant. Because of the complexity involved in these situations, whenever the auditor determines that there is evidence of fraud, he or she should refer to the reporting requirements in SAS 82 (see AU sec. 316. 38–.40) and should consider the need to consult with legal counsel.

- SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317). The auditor is responsible to assure himself or herself that the audit committee, or others with equivalent authority and responsibility, is adequately informed with respect to illegal acts that come to the auditor's attention. The auditor need not communicate matters that are clearly inconsequential (see AU sec. 317.17).
- SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801).

The ASB's omnibus exposure draft, *Audit Adjustments, Reporting on Consistency, and Service Organizations* (see "Recent Exposure Drafts" in this Alert), would, if adopted amend SAS No. 61 to require the auditor to inform the audit committee about uncorrected misstatements brought to management's attention by the auditor that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

On the Horizon

Improving the Effectiveness of Corporate Audit Committees

What are the recommendations of the Blue Ribbon Committee report on audit committees?

The *Report and Recommendations of the Blue Ribbon Committee* (the Committee) *on Improving the Effectiveness of Corporate Audit Committees* (the Report) was released in March 1999. The Committee, sponsored by the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE), developed this report to put forth recommendations aimed at enhancing the effectiveness of audit committees.[16] The recommendations seek to strengthen the independence of the audit committee, make the audit committee more effective, and address mechanisms for accountability among the audit committee, the outside auditors, and management.

In response, the ASB established the Audit Committee Effectiveness Task Force to address the report's recommendations. Two of the recommendations (numbers 8 and 10) suggest changes to GAAS. As a result of the Committee's recommendations, and in conjunction with actions expected to be taken by NYSE, NASD, and the SEC, in a collaborative effort to improve audit committee effectiveness, the task force reviewed SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), and SAS No. 71, *Interim Financial Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 722), to determine if these sections should be amended to reflect recommendations 8 and 10. The ASB has issued an exposure draft of proposed amendments to SAS Nos. 61 and 71 that are responsive to the recommendations. If approved, the amendments would become effective for fiscal and calendar years beginning in 2000.

> Help Desk—The exposure draft is available at http://www.aicpa.org/members/div/auditstd/drafts.htm. The comment period ends on November 30, 1999. In addition, the SEC has proposed new rules to improve disclosure about the functioning of corporate audit committees and to enhance the reliability and credibility of financial statements of public companies. Visit the SEC's Web site at http://www. sec.gov/news/press/99-127.txt.

To enhance your understanding of the concerns relating to the effectiveness of audit committees, and the proposed solutions, a summary of the report's recommendations follows.

[16] The National Association of Corporate Directors (NACD) also has a Blue Ribbon Commission on Audit Committees. The report is expected to be released before year end.

- Recommendation 1—*Definition of independence for purposes of service on an audit committee:* Members of the audit committee shall be considered independent if they have no relationship to the corporation that may interfere with the exercise of their independence from management and the corporation. (The Report includes examples of such relationships).
- Recommendation 2—*Require an audit committee comprised solely of independent directors:* Listed companies with market capitalization above $200 million[17] should have an audit committee comprised solely of independent directors.
- Recommendation 3—R*equire a minimum audit committee size and increased financial literacy:* Listed companies with market capitalization above $200 million17 should have an audit committee comprising a minimum of three directors, each of whom is or becomes financially literate after appointment to the committee, and further that at least one member of the audit committee have accounting or related financial management expertise
- Recommendation 4—*Require a written charter:* Each listed company must adopt a written charter that is approved by the full board of directors and that specifies the scope of the committee's responsibilities and how it carries out those responsibilities, including structure; process, membership requirements; and review and reassess the adequacy of the audit committee charter annually. (Sample audit committee charters are included as appendices to the Report).
- Recommendation 5—*Require annual public disclosure of audit committee activities:* The SEC should promulgate rules requiring audit committees for each reporting company

[17] The NYSE is recommending that this exemption be eliminated. This decision was based on the COSO fraud report finding that most fraud occurs in small companies with market capitalization well below $200 million.

to disclose in the proxy statement whether the committee has adopted a written charter.

- Recommendation 6—*Outside auditor accountability:* Audit committee charters must specify that the outside auditor is ultimately accountable to the board of directors and the audit committee as representatives of shareholders, and that these shareholder representatives have the ultimate authority and responsibility to select, evaluate, and, where appropriate, replace the outside auditor.

- Recommendation 7—*Discussion with outside auditor regarding independence:* The committee charter should specify that the audit committee is responsible for ensuring its receipt from the outside auditors of a written statement delineating all relationships between the auditor and the company (consistent with ISB Standard No. 1), and that the audit committee is also responsible for actively engaging in a dialogue with the auditor with respect to any disclosed relationships or services that may have an impact on the objectivity and independence of the auditor.

- Recommendation 8—*Outside auditor's discussion of quality of financial reporting:* GAAS should require that a company's outside auditor discuss with the audit committee the auditor's judgements about the quality, not just the acceptability, of the company's accounting principles as applied in its financial reporting.

- Recommendation 9—*Require audit committee annual letter to shareholders:* The SEC should require all reporting companies to include a letter from the audit committee in the company's annual report to shareholders and Form 10-K annual report. The report details disclosures that would be required in such a letter.

- Recommendation 10—*Require interim reviews:* The SEC should require that a reporting company's outside auditor conduct a review in accordance with SAS No. 71, *Interim Financial Information* (AICPA, *Professional Standards,* vol. 1, AU sec. 722), prior to the company's filing of its Form 10-Q. In addition, SAS No. 71 should be amended to require that a reporting company's outside auditor discuss with the committee, the matters described in SAS No. 61, *Communication With Audit Committees*, prior to the filing of Form 10-Q.

Help Desk—The above represents only a brief summary of the report's recommendations. It is highly recommended that the report be read in its entirety. The "whys" behind the recommendations included in the full report can offer some useful insights to auditors, for example, when considering the effectiveness of a client's audit committees (that is, when considering the control environment pursuant to SAS No. 55). The full text of the report can be found at http://www.nyse.com/press/publications.html or http://www.nasd.com

Continuous Auditing

What is continuous auditing?

Continuous auditing is a methodology that enables the auditor to provide assurance on a subject matter simultaneously with, or very shortly after, the occurrence of events underlying the subject matter. A joint report issued by the Canadian Institute of Charted Accountants (CICA) and the ASB titled *Continuous Auditing* (Product No. 022510kk) discusses this topic. This report, available from the AICPA, discusses the concept, issues, and viability of providing continuous assurance services.

The report discusses how planning, performing, and reporting on a hypothetical continuous audit engagement might occur within the context of existing U.S. and Canadian assurance standards. The case study focuses on characteristics that distinguish continuous audits from other kinds of audits. Significant differences include the need for highly reliable automated systems providing the subject matter, and the ability to obtain audit evidence using highly automated audit tools and techniques that are integrated with the entity's systems and controls. The case study also illustrates how the provision of continuous audits may challenge the requirements of existing assurance standards. The report identifies areas where further research is needed for continuous audit services to evolve.

In exploring the issues likely to be encountered in providing continuous assurance, the study takes a first step in moving the profession toward what the Elliott Committee called "a new audit paradigm" characterized by "a set of real time financial and non-financial information accompanied by continuous assurance." This year, the ASB will take another step in that direction by hosting a roundtable on continuous auditing for diverse interested parties to further explore the issues and to identify specific coordinated actions to be taken.

> Help Desk—For more information on continuous auditing, get the research report titled *Continuous Auditing* (product no. 022510kk), available from the AICPA Order Department (Member Satisfaction).

Beyond the Audit

Assurance Services Alerts

What are Assurance Services Alerts?

As discussed in last year's Alert, the AICPA's Special Committee on Assurance Services (SCAS) identified ElderCare Services as an assurance service that CPAs could provide. With the formation of the SCAS's Electronic Commerce Task Force came the development of an assurance service called CPA WebTrust. These emerging practice areas have generated a significant level of interest. To address this interest, the AICPA's Accounting and Auditing Publications Team has introduced a new series titled Assurance Services Alerts. The Alerts in this series serve both as an introduction to those who are unfamiliar with CPA ElderCare and CPA WebTrust, as well as an update of important new developments for those who have expanded their practice to include these engagements.

The premier entries into the Assurance Services Alerts series are *CPA ElderCare Services—1999* and *CPA WebTrust—1999*. Among other things, these publications explain—

- The nature and purpose of these new services.
- How to get started.
- Applicable professional standards.
- Sources of additional information.
- Recent practice developments.

The information provided in these Alerts will assist you in ensuring your long-term professional growth by tapping into the full potential of *CPA ElderCare* and *CPA WebTrust* services.

SysTrust℠

What Is SysTrust℠?

The AICPA and the CICA are introducing a new professional service to provide assurance on the reliability of systems. SysTrust℠ is an assurance service developed by the Assurance Services Executive Committee (ASEC) of the AICPA and the Assurance Services Development Board (ASDB) of the CICA to be provided by public accountants. It is designed to increase the comfort of management, customers, and business partners with the systems that support a business or a particular activity. Potential users of this service are shareholders, creditors, bankers, business partners, third-party users who outsource functions to other entities, stakeholders, and anyone who in some way relies on the continued availability, integrity, security, and maintainability of a system. The SysTrust service will help differentiate entities from their competitors because entities that undergo the rigors of a SysTrust engagement will presumably be better service providers—attuned to the risks posed by their environment and equipped with the controls that address those risks.

The SysTrust service entails the public accountant providing an assurance service in which he or she evaluates and tests whether a system is reliable when measured against four essential reliability principles. A reliable system is one that is capable of operating without material error, fault, or failure during a specified period in a specified environment. The following four principles are used to evaluate whether a system is reliable:

1. *Availability*—The system is available for operation and use at times set forth in service-level statements or agreements.

2. *Security*—The system is protected against unauthorized physical and logical access.

3. *Integrity*—System processing is complete, accurate, timely, and authorized.

4. *Maintainability*—The system can be updated when required in a manner that continues to provide for system availability, security, and integrity.

For each of the four principles, criteria have been established against which a system can be evaluated. The SysTrust criteria are designed to be complete, relevant, objective, and measurable and to address all of the system components (infrastructure, software, people, procedures, and data) and their relationship among them. All of the SysTrust criteria must be satisfied for a system to be deemed reliable. In determining whether a deviation from a specified criterion is material to that criterion, due consideration should be given to the anticipated users of the information and the types of decisions they are expected to make based on the information provided by the system.

The objective of a systems reliability engagement is for the practitioner to issue an attestation/assurance report on whether management maintained effective controls over its system to enable the system to function reliably. The system is evaluated against the SysTrust principles and criteria. The practitioner determines whether controls over the system exist and performs tests to determine whether those controls were operating effectively during the period covered by the attestation/assurance report. Management must provide the practitioner with an assertion regarding the availability, security, integrity, and maintainability of the system.

The practitioner may report on either of the following:

1. Management's assertion that it maintained effective controls over the reliability of the system during the period covered by the report.
2. The subject matter—that is, the effectiveness of the controls over the reliability of the system during the period covered by the report.

If one or more criteria have not been achieved, the practitioner can issue a qualified or adverse report. However, when issuing a qualified or adverse report the practitioner should report directly on the subject matter rather than on the assertion. Since the concept of system reliability is dynamic rather than static, SysTrust reports will always cover a historical period of time as opposed to a point in time. Although the determination of an appropriate period should be at the discretion of the practitioner and the reporting entity, reporting periods of less than three months generally would not be deemed meaningful.

> Help Desk—For more information about this new assurance service, and the availability of additional guidance, contact Erin Mackler, AICPA technical manager, Assurance Services, telephone: (212) 596-6149 or Email: emacker@aicpa.org.

New Auditing and Attestation Pronouncements

What new auditing and attestation pronouncements have been issued this year?

New Auditing Pronouncements

In this section we present brief summaries of recently issued auditing pronouncements. The summaries are for informational purposes only, and should not be relied on as a substitute for a complete reading of the applicable standard.

At the time this Alert went to press, no new SASs had been issued during 1999. For proposed SASs that are in the pipeline, see the "Recent Exposure Drafts" section of this Alert.

Reminder—Don't forget that SAS No. 87, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 532), became effective for reports issued after December 31, 1998. As detailed in last year's Alert, SAS No. 87 provides guidance to auditors in determining whether an engagement requires a restricted-use report and, if so, what elements to include in that report.

SOP 99-1, *Guidance to Practitioners in Conducting and Reporting on an Agreed-Upon Procedures Engagement to Assist Management in Evaluating the Effectiveness of Its Corporate Compliance Program*, was issued in May 1999 under the authority of the ASB. This SOP provides guidance to practitioners in conducting and reporting on an agreed-upon procedures engagement performed pursuant to the AICPA SSAEs to assist a health care provider in evaluating the effectiveness of its corporate compliance program consistent with the requirements of a Corporate Integrity Agreement (CIA) entered into with the Office of Inspector General (OIG) of the U.S. Department of Health and Human Services. CIAs are specific to the entity involved; consequently, users of the SOP should be familiar with the specific requirements of the entity's CIA.

A complete listing of all SOPs issued this year by the AICPA are included in the section titled "New AICPA Statements of Position" in this Alert.

New Attestation Standard

- SSAE No. 9, *Amendments to Statement on Standards for Attestation Engagements Nos. 1, 2, and 3.*[18] The SSAE—
  - Enables a practitioner to directly report on specified subject matter, such as an entity's internal control over financial reporting, rather than on management's assertion about the internal control. In either case, the

practitioner is required to obtain management's assertion as a condition of engagement performance.

- Eliminates, in certain cases, the requirement for a separate presentation of management's assertion if the assertion is included in the introductory paragraph of the practitioner's report.
- Revises the reporting guidance on the SSAEs so that SSAE reports contain elements that are similar to those included in auditor's reports on historical financial statements, as prescribed in SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508).
- States that the practitioner ordinarily should express his or her conclusion directly on the subject matter, rather than on management's assertion, when conditions exist that result in one or more deviations from the criteria used to present the subject matter.
- Provides guidance on the relationship between the SSAEs and the Statements on Quality Control Standards (SQCSs).

New Audit Issues Task Force Advisory[19]

AITF Advisory: *Reporting the Adoption of SOP 98-2*

In March 1998, the Accounting Standards Executive Committee (AcSEC) issued SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*, which is effective for financial statements for years beginning on or after Dec. 15, 1998. The adoption of the SOP may change amounts reported as program expense, management and general expense, and fundraising expense, but will not change total expenses or changes in net assets. In discussing the import of the classifications covered by the SOP, paragraph C-6 notes that external financial statement users of

[18] SSAE No. 9 has been integrated within AT sections 100, 400, and 500 of AICPA, *Professional Standards*, vol. 1.

Not-for-Profit Organization's financial statements focus on and have perceptions about amounts reported as program, management and general, and fund raising.

The Audit Issues Task Force (AITF) of the ASB is advising auditors that the adoption of the SOP, whether or not retroactively applied, is an accounting change for which the consistency standard is applicable. If the change has a material effect on the comparability of the entity's financial statements, the auditor should refer to the change in an explanatory paragraph of his or her report in accordance with SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508.16).

Reporting Guidance on GASB Year 2000 Technical Bulletin

In October 1998 the Government Accounting Standards Board (GASB) issued Technical Bulletin (TB) 98-1, *Disclosures about Year 2000 Issues*[20], which was effective for financial statements on which the auditor's report is dated after October 31, 1998. Among other things, it required state and local governments to disclose a general description of the Year 2000 Issue as it relates to their organizations, including a description of the stages of work in process or completed to make computer systems and other electronic equipment critical to conducting operations in a year-2000-compliant fashion.

The AICPA expressed concerns about the nature of the required Technical Bulletin (TB) disclosures. The AITF is advising auditors to be cautious about being associated with the disclosures required by the TB. Because of the unprecedented nature of the Year 2000 Issue, its effects and the success of related remediation efforts will not be fully determinable until the year 2000 and thereafter. Accordingly, sufficient evidence may not exist to

[19] From time to time the AITF issues Advisories to provide nonauthoritative guidance on current developments or recently issued authoritative literature.

[20] Subsequently amended by TB 99-1, *Disclosures about Year 2000 Issues—an amendment of Technical Bulletin 98-1*. See the Audit Risk Alert *State and Local Governmental Developments—1999* for a full discussion of this issue.

support the required TB disclosures. Therefore, auditors may need to consider modifying their audit opinions with respect to such disclosures.

> Help Desk—Illustrative report language has been developed by the AITF to assist auditors when preparing such reports. It is available from the AICPA Fax Hotline at (201) 938-3787, document no. 474, and the AICPA Web site at http://www.aicpa.org/members/y2000/gasb98-1.htm.

Year 2000 Interpretation on SAS No. 70 Being Considered

The Auditing Standards Board is reviewing an Interpretation of SAS No. 70, *Reports on the Processing of Transactions by Service Organizations*, which provides guidance on a service auditor's reporting responsibility when he or she becomes aware that a service organization's computer programs, which correctly processed data during the period covered by the service auditor's examination, did not correctly process data subsequent to the period covered by the service auditor's examination and prior to the date of the service auditor's report (the subsequent events period) because of the Year 2000 Issue. The proposed Interpretation states that since SAS No. 70 does not apply to design deficiencies that potentially could affect processing in future periods, the service auditor would not be required to report such design deficiencies in his or her report. However, potential processing problems differ from processing problems that have actually occurred and come to the service auditor's attention during the subsequent events period. Therefore, if a service auditor becomes aware of such problems, the service auditor should determine whether management has disclosed that information in section 4 of the service auditor's report, "Other Information Provided by the Service Organization." If management has not disclosed that information, the service auditor should include that information in section 3 of the service auditor's report, "Information Provided by the Service Auditor," and should consider adding a paragraph to his or her report highlighting the disclosure. If management has disclosed that information in section 4 of the service auditor's report, the service auditor should disclaim an opinion on that information because it is not covered by the service auditor's report. Auditors should be alert to the issuance of a final Interpretation.

Executive Summary—New Auditing and Attestation Pronouncements

- At the time this Alert went to press, no new SASs had been issued during 1999. For proposed SASs that are in the pipeline, see the "Recent Exposure Drafts" section of this Alert.
- New Statement on Standards for Attestation Engagements (SSAE): SSAE 9, *Amendments to Statement on Standards for Attestation Engagement Nos. 1, 2, and 3.*
- New ASB SOP: SOP 99-1, Guidance to Practitioners in Conducting and Reporting on an Agreed-Upon Procedures Engagement to Assist Management in Evaluating the Effectiveness of Its Corporate Compliance Program (A complete listing of SOPs issued by the AICPA this year can be found in the "New AICPA Statements of Position" section of this Alert.)
- New AITF Guidance—AITF Advisory: *Reporting the Adoption of SOP 98-2.* The AITF also developed illustrative reporting guidance on Year 2000 Disclosures made under the Guidance on GASB Year 2000 Technical Bulletin.
- Proposed Auditing Interpretation—In addition, as we went to press, a Year 2000 Interpretation on SAS No. 70 was being considered.

Recent GAAP Pronouncements

What new accounting pronouncements have been issued this year?

New FASB Pronouncements

In this section we present brief summaries of recently issued accounting pronouncements. The summaries are for informational purposes only, and should not be relied on as a substitute for a complete reading of the applicable standard.

FASB Statement No. 134, *Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise*, an amendment of

FASB Statement No. 65. FASB Statement No. 65, as amended, requires that after the securitization of a mortgage loan held for sale, an entity engaged in mortgage banking activities classify the resulting mortgage-backed security as a trading security. FASB Statement No. 134 further amends FASB Statement No. 65 to require that after the securitization of mortgage loans held for sale, an entity engaged in mortgage banking activities classify the resulting mortgage-backed securities or other retained interests based on its ability and intent to sell or hold those investments. This Statement conforms the subsequent accounting for securities retained after the securitization of mortgage loans by a mortgage banking enterprise with the subsequent accounting for securities retained after the securitization of other types of assets by a nonmortgage banking enterprise. FASB Statement No. 134 is effective for the first fiscal quarter beginning after December 15, 1998.

FASB Statement No. 135, *Rescission of FASB Statement No. 75 and Technical Corrections*, rescinds FASB Statement No. 75, *Deferral of the Effective Date of Certain Accounting Requirements for Pension Plans of State and Local Governmental Units*. GASB Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, was issued November 1994, and establishes financial reporting standards for defined benefit pension plans and for the notes to the financial statements of defined contribution plans of state and local governmental entities. FASB Statement No. 75 is, therefore, no longer needed. FASB Statement No. 135 also amends FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, to exclude from its scope plans that are sponsored by and provide benefits for the employees of one or more state or local governmental units.

This Statement also amends other existing authoritative literature to make various technical corrections, clarify meanings, or describe applicability under changed conditions. FASB Statement No. 135 is effective for financial statements issued for fiscal years ending after February 15, 1999. Earlier application is encouraged.

FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds*

Contributions for Others, establishes standards for transactions in which an entity—the *donor*—makes a contribution by transferring assets to a not-for-profit organization or charitable trust—the *recipient organization*—that accepts the assets from the donor and agrees to use those assets on behalf of or transfer those assets, the return on investment of those assets, or both to another entity—the *beneficiary*—that is specified by the donor. It also establishes standards for transactions that take place in a similar manner but are not contributions because the transfers are revocable, repayable, or reciprocal.

This Statement requires a recipient organization that accepts cash or other financial assets from a donor and agrees to use those assets on behalf of or transfer those assets, the return on investment of those assets, or both to a specified unaffiliated beneficiary to recognize the fair value of those assets as a liability to the specified beneficiary concurrent with recognition of the assets received from the donor. However, if the donor explicitly grants the recipient organization variance power or if the recipient organization and the specified beneficiary are financially interrelated organizations, the recipient organization is required to recognize the fair value of any assets it receives as a contribution received. Not-for-profit organizations are financially interrelated if (1) one organization has the ability to influence the operating and financial decisions of the other and (2) one organization has an ongoing economic interest in the net assets of the other. This Statement does not establish standards for a trustee's reporting of assets held on behalf of specified beneficiaries, but it does establish standards for a beneficiary's reporting of its rights to assets held in a charitable trust.

This Statement requires that a specified beneficiary recognize its rights to the assets held by a recipient organization as an asset unless the donor has explicitly granted the recipient organization variance power. Those rights are either an interest in the net assets of the recipient organization, a beneficial interest, or a receivable. If the beneficiary and the recipient organization are financially interrelated organizations, the beneficiary is required to recognize its interest in the net assets of the recipient organization and adjust that interest for its share of the change in net assets of the recipient organization. If the beneficiary has an unconditional right to receive all or a portion of the specified cash flows from a charitable trust or other identifiable pool of assets, the beneficiary is required to recognize that beneficial interest, measuring and subsequently remeasuring it at fair value, using a valuation technique such as the present value of the estimated expected future cash flows. If the recipient organization is explicitly granted variance power, the specified beneficiary does not recognize its potential for future distributions from the assets held by the recipient organization. In all other cases, a beneficiary recognizes its rights as a receivable.

This Statement describes four circumstances in which a transfer of assets to a recipient organization is accounted for as a liability by the recipient organization and as an asset by the resource provider because the transfer is revocable or reciprocal. Those four circumstances are if (1) the transfer is subject to the resource provider's unilateral right to redirect the use of the assets to another beneficiary, (2) the transfer is accompanied by the resource provider's conditional promise to give or is otherwise revocable or repayable, (3) the resource provider controls the recipient organization and specifies an unaffiliated beneficiary, or (4) the resource provider specifies itself or its affiliate as the beneficiary and the transfer is not an equity transaction. If the transfer is an equity transaction and the resource provider specifies itself as beneficiary, it records an interest in the net assets of the recipient organization (or an increase in a previously recognized interest). If the resource provider specifies an affiliate as beneficiary, the resource provider records an equity transaction as a separate line item in its statement of activities, and the affiliate named as beneficiary records an interest in the net assets of the recipient organization. The recipient organization records an equity transaction as a separate line item in its statement of activities.

This Statement requires certain disclosures if a not-for-profit organization transfers assets to a recipient organization and specifies itself or its affiliate as the beneficiary or if it includes in its financial statements a ratio of fundraising expenses to amounts raised.

This Statement incorporates without reconsideration the guidance in FASB Interpretation No. 42, *Accounting for Transfers of Assets in Which a Not-for-Profit Organization Is Granted Variance Power*, and supersedes that Interpretation. This Statement is effective for financial statements issued for fiscal periods beginning after December 15, 1999, except for the provisions incorporated from Interpretation No. 42, which continue to be effective for fiscal years ending after September 15, 1996. Earlier application is encouraged. This Statement may be applied either by restating the financial statements of all years presented or by recognizing the cumulative effect of the change in accounting principle in the year of the change.

FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133*—an amendment of FASB Statement No. 133. FASB Statement No. 137 amends Statement 133 as follows: (1) the first sentence of paragraph 48 is replaced by the following: "This Statement shall be effective for all fiscal quarters of all fiscal years beginning after June 15, 2000." (2) Paragraph 50 is replaced by the following : "At the date of initial application, an entity shall choose to either (a) recognize as an asset or liability in the statement of financial position all embedded derivative instruments that are required pursuant to paragraphs 12-16 to be separated from their host contracts or (b) select either January 1, 1998 or January 1, 1999 as a transition date for embedded derivatives. If the entity chooses to select a transition date, it shall recognize as separate assets and liabilities (pursuant to paragraphs 12-16) only those derivatives embedded in hybrid instruments issued, acquired, or substantively modified by the entity on or after the selected transition date. That choice is not permitted to be applied to only some of an entity's individual hybrid instruments and must be applied on an all-or-none basis." The Statement became effective upon its issuance in June 1999.

FASB Interpretation 43, *Real Estate Sales*—This Interpretation of FASB Statement No. 66, *Accounting for Sales of Real Estate*, clarifies that the phrase "all real estate sales" includes sales of real estate with property improvements or integral equipment that cannot be removed and used separately from the real estate without incurring significant costs. For example, office buildings, manufacturing facilities, power plants, and refineries are included in this description. The Interpretation is effective for all sales of real estate with property improvements or integral equipment entered into after June 30, 1999.

Executive Summary—New FASB Pronouncements

- FASB Statement No. 134, *Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise, an amendment of FASB Statement No. 65.*
- FASB Statement No. 135, *Rescission of FASB Statement No. 75 and Technical Corrections.*
- FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others.*
- FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133*—an amendment of FASB Statement No. 133.
- FASB Interpretation 43, *Real Estate Sales.*

New AICPA Statements of Position

SOP 98-9, *Modification of SOP 97-2,* Software Revenue Recognition, *With Respect to Certain Transactions,* was issued in December 1998.This SOP amends paragraphs 11 and 12 of SOP 97-2 to require recognition of revenue using the residual method when (1) there is vendor-specific objective evidence of the fair values of all undelivered elements in a multiple-element arrangement that is not accounted for using long-term contract accounting, (2) vendor-specific objective evidence of fair value does not exist for one or more of the delivered elements in the arrangement, and (3) all revenue-recognition criteria in SOP 97-2 other than the requirement for vendor-specific objective evidence of the fair value of each delivered element of the arrangement are satisfied. Under the residual method, the arrangement fee is recognized as follows: (1) the total fair value of the undelivered elements, as indicated by vendor-specific objective evidence, is deferred and subsequently recognized in accordance with the relevant sections of SOP 97-2 and (2) the difference between the total arrangement fee and the amount deferred for the undelivered elements is recognized as revenue related to the delivered elements.

Effective December 15, 1998, the SOP amends SOP 98-4, *Deferral of the Effective Date of a Provision of SOP 97-2,* Software Revenue Recognition, to extend the deferral of the application of certain passages of SOP 97-2 provided by SOP 98-4 through fiscal years beginning on or before March 15, 1999. All other provisions of the SOP are effective for transactions entered into in fiscal years beginning after March 15, 1999. Earlier adoption is permitted as of the beginning of fiscal years or interim periods for which financial statements or information have not been issued. Retroactive application of the provisions of the SOP is prohibited.

SOP 99-1, *Guidance to Practitioners in Conducting and Reporting on an Agreed-Upon Procedures Engagement to Assist Management in Evaluating the Effectiveness of Its Corporate Compliance Program*, is discussed in the "New Auditing and Attestation Pronouncements" section of this Alert.

SOP 99-2, *Accounting for and Reporting of Postretirement Medical Benefit (401(h)) Features of Defined Benefit Pension Plans*, amends chapters 2 and 4 of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* (the Guide) and specifies the accounting for and disclosure of 401(h) features of defined benefit pension plans, by both defined benefit pension plans and health and welfare benefit plans.

SOP 99-2 requires—

1. Defined benefit pension plans to record the aggregate amount of net assets held in a 401(h) account related to health and welfare plan obligations for retirees as both assets and liabilities on the face of the statement of net assets available for pension benefits in order to arrive at net assets available for pension benefits.

2. 401(h) account assets used to fund health benefits, and the changes in those assets, to be reported in the financial statements of the health and welfare benefit plan. Benefit obligations related to the 401(h) account are also required to be reflected in the health and welfare plan financial statements.

3. Defined benefit pension plans to disclose the fact that the 401(h) account assets are available only to pay retirees' health benefits.

4. Health and welfare benefit plans to disclose in the notes to the financial statements the fact that retiree health benefits are funded partially through a 401(h) account of the defined benefit pension plan.

The SOP is effective for financial statements for plan years beginning after December 15, 1998, with earlier application encouraged. Accounting changes adopted to conform to the provisions of this SOP should be made retroactively by a restatement of financial statements for prior periods.

SOP 99-3, *Accounting for and Reporting of Certain Defined Contribution Plan Investments and Other Disclosure Matters*, amends chapters 3 and 4 of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*; SOP 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined Contribution Plans*; and SOP 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans*. This SOP simplifies disclosures for certain investments and supersedes AICPA Practice Bulletin 12, *Reporting Separate Investment Fund Option Information of Defined Contribution Pension Plans* (PB 12).

SOP 99-3—

- Amends paragraph 3.20 of the Guide to eliminate the previous requirement for a defined contribution plan to present plan investments by general type for participant-directed investments in the statement of net assets available for benefits.

- Amends paragraph 3.28(k) and supersedes paragraph 3.28(l) of the Guide and supersedes PB 12 to eliminate the requirement for a defined contribution plan to disclose participant-directed investment programs and to eliminate the requirement to disclose the total number of units and the net asset value per unit during the period, and at the end of the period, by defined contribution pension plans that assign units to participants.
- Amends paragraph 3.28(g) of the Guide to require a defined contribution plan to identify nonparticipant-directed investments that represent 5 percent or more of net assets available for benefits.
- Amends paragraphs 3.28(p) and 4.57 of the Guide, paragraph 53 of SOP 92-6, and paragraph 15 of SOP 94-4 to eliminate the requirement for defined contribution plans, including both health and welfare benefit plans and pension plans, to disclose benefit-responsive investment contracts by investment fund option.
- Replaces exhibits E-1 through E-5 in the Guide.

SOP 99-3 is effective for financial statements for plan years ending after December 15, 1999. Earlier application is encouraged for fiscal years for which annual financial statements have not been issued. If the previously required "by-fund" disclosures are eliminated, the reclassification of comparative amounts in financial statements for earlier periods is required.

The following are AcSEC pronouncements with effective dates in 1999:

- SOP 98-7, *Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk*, effective for financial statements for fiscal years beginning after June 15, 1999, with earlier application encouraged.
- Reminder—SOP 98-5, *Reporting on the Costs of Start-Up Activities*, is effective for fiscal years beginning after December 15, 1998.

Executive Summary—New AICPA Statements of Position

- SOP 98-9, *Modification of SOP 97-2,* Software Revenue Recognition, With Respect to Certain Transactions.
- SOP 99-1, *Guidance to Practitioners in Conducting and Reporting on an Agreed-Upon Procedures Engagement to Assist Management in Evaluating the Effectiveness of Its Corporate Compliance Program* (See the "New Auditing and Attestation Pronouncements" section of this Alert for a description of this SOP).
- SOP 99-2, *Accounting for and Reporting of Postretirement Medical Benefit (401(h)) Features of Defined Benefit Pension Plans Amendment to the AICPA Audit and Accounting Guide Audits of Employee Benefit Plans.*
- SOP 99-3, *Accounting for and Reporting of Certain Defined Contribution Plan Investments and Other Disclosure Matters.*
- Reminder—SOP 98-7 is effective for financial statements for fiscal years beginning after June 15, 1999, with earlier application encouraged. SOP 98-5 is effective for fiscal years beginning after December 15, 1998.

EITF Consensus Positions

The Emerging Issues Task Force (EITF) was established by the FASB in July 1984 to assist in improving financial reporting through the timely identification, discussion, and resolution of financial issues within the framework of existing authoritative literature. The application of EITF consensuses (category c of the GAAP hierarchy) effective after March 15, 1992 is mandatory under SAS No. 69, *The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report* (AICPA, *Professional Standards,* vol. 1, AU sec. 411). Any EITF consensus issued before March 16, 1992, becomes effective in the hierarchy for initial application of an accounting principle after March 15, 1993. The EITF meets approximately every eight weeks. All meetings are announced by the FASB in its *Action Alert,* together with a listing of the topics on the meeting agenda. The table below contains a summary of EITF issues discussed from November 1998 through the September 1999 meetings.

EITF Issue No.	*Description*	*Date of Consensus/Status*
87-6	*87-6(c) Use of Stock Option Shares to Cover Tax Withholding*	Consensus reached March 24–25, 1999.
95-22	*Balance Sheet Classification of Borrowings Outstanding under Revolving Credit Agreements That Include both a Subjective Acceleration Clause and a Lock-Box Arrangement*	Originally discussed and consensus reached November 15–16, 1995. Additional consensus reached November 18–19, 1998.
98-2	*Accounting by a Subsidiary or Joint Venture for an Investment in the Stock of Its Parent Company or Joint Venture Partner*	Originally discussed March 18-19, 1998. Further discussion expected after the Board concludes its project on the Interpretation of Opinion 25.
98-3	*Determining Whether a Transaction Is an Exchange of Similar Productive Assets or a Business Combination*	Originally discussed March 18–19, 1998. Further discussion planned.
98-4	*Accounting by a Joint Venture for Businesses Received at Its Formation*	Originally discussed March 18–19, 1998. Further discussion planned.
98-5	*Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios*	Consensuses reached May 19–20, 1999.
98-6	*Investor's Accounting for an Investment in a Limited Partnership Investment When the Investor Is the Sole General Partner and the Limited Partners Have Certain Approval Or Veto Rights*	Originally discussed July 23, 1998. No consensus reached and no further discussion planned.
98-9	*Accounting for Contingent Rent*	Originally discussed with consensuses reached May 21, 1998. At September 23–24, 1998, prior consensus on lessee accounting was withdrawn and new consensus reached. At November 18–19, 1998, a May 21, 1998 consensus was withdrawn and transition guidance was given. This issue

EITF Issue No.	*Description*	*Date of Consensus/Status*
		may be discussed at a future meeting.
98-10	*Accounting for Contracts Involved in Energy Trading and Risk Management Activities*	Consensus reached November 18–19, 1998. Revisions made September 23, 1999.
98-11	*Accounting for Acquired Temporary Differences in Certain Purchase Transactions That Are Not Accounted for as Business Combinations*	Consensuses reached May 19–20, 1999.
98-12	*Application of Issue No. 96-13 to Forward Equity Sales Transactions.*	Consensus reached November 18–19, 1998.
98-13	*Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee*	Consensus reached January 21, 1999.
98-14	*Debtor's Accounting for Changes in Line-of-Credit or Revolving-Debt Arrangements*	Consensus reached March 24–25, 1999.
98-15	*Structured Notes Acquired for a Specified Investment Strategy*	Consensus reached November 18–19, 1998.
99-1	*Accounting for Debt Convertible Into the Stock of a Consolidated Subsidiary*	Consensus reached March 24–25, 1999. No further discussion planned.
99-2	*Accounting for Weather Derivatives*	Consensuses reached July 22, 1999.
99-3	*Application of Issue No. 96-13 to Derivative Instruments with Multiple Settlement Alternatives*	Consensuses reached May 19–20, 1999.
99-4	*Accounting for Stock Received from the Demutualization of a Mutual Insurance Company*	Consensus reached May 19–20, 1999.
99-5	*Accounting for Pre-Production Costs Related to Long-Term Supply Arrangements*	Consensus reached September 23, 1999.
99-6	*Impact of Acceleration Provisions in Grants Made between Initiation and Consummation of a Pooling-of-Interest Business Combination*	Consensus reached May 19–20, 1999.

(continued)

EITF Issue No.	*Description*	*Date of Consensus/Status*
99-7	*Accounting for an Accelerated Share Repurchase Program*	Consensus reached July 22, 1999.
99-8	*Accounting for Transfers of Assets That Are Derivative Instruments but That Are Not Financial Assets*	Consensus reached September 23, 1999.
99-9	*Effect of Derivative Gains and Losses on the Capitalization of Interest*	Consensus reached July 22, 1999.
99-10	*Percentage Used to Determine the Amount of Equity Method Losses*	Consensus reached September 23, 1999.
99-11	*Subsequent Events Caused by Year 2000*	Originally discussed July 22, 1999. Further discussion planned.
99-12	*Accounting for Formula Arrangements under EITF Issue No. 95-19, "Determination of the Measurement Date for the Market Price of Securities Issued in a Purchase Business Combination"*	September 23, 1999. Further discussion planned.
99-13	*Application of EITF Issue No. 97-10, The Effect of Lessee Involvement in Asset Construction, and FASB Interpretation No. 23, Leases of Certain Property Owned by a Governmental Unit or Authority, to Entities That Enter into Leases with Governmental Entities*	Consensus reached September 23, 1999.

Independence and Other Ethics Standards

The ISB's First Standard

What is the Independence Standards Board? Has it issued any standards that you must follow?

The Independence Standards Board (ISB) was established in May 1997 as part of an agreement between the AICPA and the SEC. Its charge is to establish, maintain and improve independence standards for external auditors of SEC registrants. Although the SEC retains its statutory authority to define independence, it recognizes the responsibility of the ISB in establishing independence standards and interpretations for auditors of public entities. The SEC also considers principles, standards, interpretations, and practices issued by the ISB as having substantial authoritative support.

The pronouncements of the ISB apply to auditors of publicly held entities only. The functioning of the ISB does not affect the authority of state licensing or disciplinary authorities regarding auditor independence. Also, it does not affect the AICPA rules on independence as they relate to audits of nonpublic entities.

The ISB adopted its first standard this year. ISB Standard No. 1, *Independence Discussions with Audit Committees*, requires auditors of public companies, at least annually, to—

1. Disclose to the audit committee of the company (or the board of directors if there is no audit committee), in writing, all relationships between the auditor and its related entities and the company and its related entities that in the auditor's professional judgement may reasonably be thought to bear on independence.
2. Confirm in the letter that, in its professional judgement, it is independent of the company within the meaning of the Securities Acts.
3. Discuss its independence with the audit committee.

This Standard is effective for audits of companies with fiscal years ending after July 15, 1999, with earlier application encouraged.[21]

The Professional Issues Task Force (PITF) has issued Practice Alert 99-1, *Guidance for Independence Discussions with Audit Committees*, to assist firms in evaluating and enhancing their policies and procedures for identifying and communicating with audit committees those judgmental matters that may reasonably be thought to bear on the auditor's independence. The Practice Alert provides examples of certain relationships that may be thought to bear on the auditor's independence, safeguards to ensure independence, a sample letter to an audit committee, and other implementation guidance.

Help Desk—Practice Alert 99-1 can be found on the AICPA Web site at http://www.aicpa.org/pubs/cpaltr/may99/supp/public.htm

In addition to its first standard, the ISB also issued Interpretation 99-1, *Impact on Auditor Independence of Assisting Clients in the Implementation of FAS 133 (Derivatives).* This Interpretation provides guidance on the auditor independence implications of likely areas of requested assistance, solely with respect to the implementation of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities.*

The Interpretation concludes that the auditor may provide consulting services on the proper application of FASB Statement No. 133, including assisting a client in gaining a general understanding of the methods, models, assumptions, and inputs used in computing a derivative's value. To ensure, however, that the auditor's independence is not threatened, as discussed in paragraph 4 of the Interpretation, the auditor may not prepare accounting entries, compute derivative values, or be responsible for key assumptions or inputs used by the client in computing derivative values. The Interpretation includes illustrative lists of permitted and prohibited services.

Help Desk—The full text of the Standard and the Interpretation, along with information about all other activities of the ISB, are posted on the ISB's Web site at http://www.cpaindependence.org

AICPA Professional Ethics Rulings and Interpretations

Ethics Interpretations and rulings are promulgated by the executive committee of the professional ethics division of the AICPA to provide guidelines on the scope and application of

[21] The *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees* (see "On the Horizon" earlier in this Alert) includes a recommendation that the listing rules for both the New York Stock Exchange and the National Association of Securities Dealers require audit committees to ensure the receipt of a formal written statement from the outside auditors consistent with ISB Standard No.1.

ethics rules but are not intended to limit such scope or application. Publication of an Interpretation or ethics ruling in the *Journal of Accountancy* constitutes notice to members. A member who departs from Interpretations or rulings shall have the burden of justifying such departure in any disciplinary hearing. The full text of the interpretations and rules presented here can be found in their entirety in the *Journal of Accountancy*. The month of their publication is provided for reference.

> Help Desk—For full information about the interpretations and rulings discussed below, visit the Professional Ethics Team Web page at http://www.aicpa.org/members/div/ethics/index.htm. You can also call the Professional Ethics Team at 1-888-777-7077, menu option 2, followed by menu option 2.

Revised Interpretations.

The Professional Ethics Executive Committee has revised the following Interpretations under the AICPA Code of Professional Conduct:

- Interpretation No. 101-3, "Performance of Other Services," of ET section 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05.), addresses the performance of other nonattest services for attest clients. The committee also deleted the following ethics rulings under rule 101 as they have been incorporated into this revised Interpretation: Ruling No. 3, "Member as Signer or Cosigner of Checks" of ET section 191, Ethics Rulings on Independence, Integrity, and Objectivity (AICPA, *Professional Standards*, vol. 2, ET sec. 191.005–.006); Ruling No. 4, "Payroll Preparation Services" of ET section 191 (AICPA, *Professional Standards*, vol. 2, ET sec. 191.007–.008); Ruling No. 7, "Member Providing Contract Services," of ET section 191 (AICPA, *Professional Standards*, vol. 2, ET sec. 191.013–.014); Ruling No. 39, "Member as Officially Appointed Stock Transfer Agent or Registrar," of ET section 191 (AICPA, *Professional Standards*, vol. 2, ET sec. 191.077–.078); Ruling No. 51, "Member Providing Legal Services," of ET section 191 (AICPA, *Professional Standards*, vol. 2. ET sec. 191.101–.102); Ruling No. 54, "Member Providing Appraisal, Valuation, or Actuarial Services," of ET section 191 (AICPA, *Professional Standards*, vol. 2, ET sec. 191.107–.108); Ruling No. 55, "Independence During Systems Implementation," of ET section 191 (AICPA, *Professional Standards*, vol. 2, ET sec. 191.109–.110); and Ruling No. 56, "Executive Search," of ET section 191 (AICPA, *Professional Standards*, vol. 2, ET sec. 191.111–.112). May 1999

- Interpretation No.102-1, "Knowing Misrepresentations in the Preparation of Financial Statements or Records," of ET section 102, *Integrity and Objectivity* (AICPA, *Professional Standards*, vol. 2, ET sec. 102.02). May 1999
- Interpretation 501-4, "Negligence in the Preparation of Financial Statements or Records," of ET section 501, *Acts Discreditable* (AICPA, *Professional Standards*, vol. 2, ET sec. 501.05). May 1999
- "Interpretation Addressing the Applicability of the AICPA Code of Professional Conduct," of ET section 91, *Applicability* (AICPA, *Professional Standards*, vol. 2, ET sec. 91.02). December 1998
- ET section 92, *Definitions* (AICPA, *Professional Standards*, vol. 2, ET sec. 92.01). December 1998
- Interpretation No.101-2, "Former Practitioners and Firm Independence," of ET section 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.04). December 1998
- Interpretation No. 505-2, "Application of Rules of Conduct to Members Who Own a Separate Business," of ET section 505 , *Form of Organization and Name* (AICPA, *Professional Standards*, vol. 2, ET sec. 505.03). December 1998
- Interpretation No.101-1, "Interpretation of Rule 101," of ET section 101 (AICPA, *Professional Standards*, vol. 2, ET sec. 101.02). May 1999

- Interpretation No.101-13, "Extended Audit Services," of ET section 101(AICPA, *Professional Standards*, vol. 2, ET sec. 101.15). September 1999

Adopted Interpretations.

The Professional Ethics Executive Committee has adopted the following new ethics interpretations under the AICPA Code of Professional Conduct:

- Interpretation No.501-7, "Failure to File Tax Return or Pay Tax Liability," of ET section 501(AICPA, *Professional Standards*, vol. 2, ET sec. 501.08). May 1999
- Interpretation No.101-14, "The Effect of Alternative Practice Structures on the Applicability of Independence Rules," of ET section 101 (AICPA, *Professional Standards*, vol. 2, ET sec. 101.16). February 1999
- Interpretation No.505-3, "Application of Rule 505 to Alternative Practice Structures," of ET section 505 (AICPA, *Professional Standards*, vol. 2, ET sec. 505.04). December 1998

Deleted Interpretations.

The Professional Ethics Executive Committee has deleted the following ethics interpretation under the AICPA Code of Professional Conduct:

- Interpretation No.505-1, Investment in Accounting Organization," of ET section 505 (AICPA *Professional Standards*, vol. 2, ET sec. 505.02). May 1999

Revised Ruling.

The Professional Ethics Executive Committee has revised the following ruling under the AICPA Code of Professional Conduct:

- Ruling No. 191, "Member Removing Client Files From an Accounting Firm," of ET section 591, *Ethics Rulings on Other Responsibilities and Practices* (AICPA, *Professional Standards*, vol. 2, ET sec. 591.381–.382). December 1998

Adopted Rulings.

The Professional Ethics Executive Committee has adopted the following new ethics rulings under the AICPA Code of Professional Conduct:

- Ruling No. 110, "Member Is Connected with an Entity That Has a Loan to or from a Client," of ET section 191 (AICPA, *Professional Standards*, vol. 2, ET section 191.220–.221). May 1999
- Ruling No. 24, "Investment Advisory Services," of ET section 391, *Ethics Rulings on Responsibilities to Clients* (AICPA, *Professional Standards*, vol. 2, ET sec. 391.047–.048). May 1999
- Ruling No. 25, of ET section 302, *Contingent Fees* (AICPA, *Professional Standards*, vol. 2, ET sec. 302). September 1999
- Ruling No. 109, "Member's Investment in Financial Services Products That Invest in Clients," of ET section 191 (AICPA, *Professional Standards*, vol. 2, ET sec. 191.218–.219). December 1998

Deleted Rulings.

The Professional Ethics Executive Committee has deleted the following ethics rulings under the AICPA Code of Professional Conduct:

- Ruling No. 22, "Member Removing Client Files from an Accounting Firm," of ET section 391 (AICPA, *Professional Standards*, vol. 2, ET sec. 391.043–.044). December 1998
- Ruling No. 139, "Partnership with Non-CPA," of ET section 591 (AICPA, *Professional Standards*, vol. 2, ET sec. 591.277–.278). December 1998
- Ruling No. 158, "Operation of Separate Data Processing Business by a Public Practitioner" (AICPA, *Professional Standards*, vol. 2, ET sec. 591.315–.316). December 1998

- Ruling No. 146, "Membership Designation," of ET section 591 (AICPA, *Professional Standards*, vol. 2, ET sec. 591.291–.292). September 1999
- See the "Revised Interpretations" section for a listing of ethics rulings deleted given their incorporation into Interpretation 101-3.

Also note that the Professional Ethics Executive Committee has inserted new language in the Interpretations Under Rule of Conduct 101: *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101) emphasizing that other regulatory agencies may have independence rules that are more restrictive than those of the AICPA. In addition, certain wording pertaining to the effect of Interpretations and rulings that existed before the adoption of the Professional Code of Conduct on January 12, 1988 was deleted. This change affects AICPA Professional Standards ET sections 101, 102, 191, 201, 202, 203, 291, 301, 391, 501, 502, 503, 505 and 591. March 1999.

PITF Practice Alerts

The PITF, established by the SEC Practice Section (SECPS) Executive committee, formulates guidance based on issues arising in litigation, peer reviews, and firm inspections to facilitate the resolution of emerging audit practice issues. This guidance takes the form of Practice Alerts. These Alerts—which are based on existing audit literature, the professional experience of the members of the PITF, and information provided by the SECPS member firms—provide auditors with information that may help them improve the efficiency and effectiveness of their audits. The information contained in Practice Alerts is nonauthoritative. It represents the views of the members of the PITF and does not represent official positions of the AICPA.

Recently Issued Practice Alerts

- Practice Alert No. 99-2, *How the Use of a Service Organization Affects Internal Control Considerations*

- Practice Alert No. 99-1, *Guidance for Independence Discussions with Audit Committees*

Previously Issued Practice Alerts

- Practice Alert No. 98-3, *Revenue Recognition Issues*
- Practice Alert No. 98-2, *Professional Skepticism and Related Topics*
- Practice Alert No. 98-1, *The Auditor's Use of Analytical Procedures*
- Practice Alert No. 97-3, *Changes in Auditors and Related Topics*
- Practice Alert No. 97-2, *Audits of Employee Benefit Plans*
- Practice Alert No. 97-1, *Financial Statements on the Internet*
- Practice Alert No. 96-1, *The Private Securities Litigation Reform Act of 1995*
- Practice Alert No. 95-3, *Auditing Related Parties and Related-Party Transactions*
- Practice Alert No. 95-2, *Complex Derivatives*
- Practice Alert No. 95-1, *Revenue Recognition Issues* (superseded by Practice Alert 98-3)
- Practice Alert No. 94-3, *Acceptance and Continuance of Audit Clients*
- Practice Alert No. 94-2, *Auditing Inventories—Physical Observations*
- Practice Alert No. 94-1, *Dealing with Audit Differences*

Help Desk—Copies of these Practice Alerts can be downloaded from the AICPA's Web site at http://www.aicpa.org/members/div/secps/lit/practice.htm.

Recent Exposure Drafts

Practitioners should note that the purpose of exposure drafts is to solicit comments from preparers, auditors, users of financial statements, and other interested parties. They are nonauthoritative and cannot be used as a basis for changing GAAS or GAAP. The following is a listing of some of the more significant exposure drafts outstanding at the time we went to press.

ASB Exposure Drafts

A proposed SAS, *Auditing Financial Instruments* (to supersede SAS No. 81, *Auditing Investments*), was issued June 10, 1999. The proposed SAS would provide updated guidance on planning and performing auditing procedures for financial statement assertions about financial instruments (including derivatives). The proposed SAS—

- Indicates that an auditor may require special skill or knowledge to plan and perform auditing procedures for certain assertions about financial instruments.
- Provides guidance on inherent risk considerations for assertions about financial instruments.
- Provides guidance on control risk considerations for assertions about financial instruments.
- Provides guidance on auditing considerations related to the initial designation of a financial instrument as a hedge and the continued application of hedge accounting.
- Indicates that a service organization's services may affect the nature, timing, and extent of the auditor's substantive tests.
- Provides guidance on substantive tests an auditor might perform when auditing valuation assertions that are dependent on management's intent and ability.
- Provides guidance on designing substantive tests of valuation assertions.

The ASB also is developing a Practice Aid that will provide guidance on how to apply the proposed SAS to assertions about specific types of financial instruments and assertions based on specific accounting requirements. The ASB plans to issue the SAS and the Practice Aid at approximately the same time and to periodically update the Practice Aid to address new accounting and auditing pronouncements and new financial instruments.

A proposed SAS, *Audit Adjustments, Reporting on Consistency, and Service Organizations* (Omnibus Statement on Auditing Standards—1999), was issued April 22, 1999. The proposed SAS (referred to as an omnibus because it addresses several unrelated topics) provides guidance to auditors in the following three areas:

- *Audit Adjustments.* The proposed SAS would establish audit requirements intended to encourage audit clients to record financial statement adjustments proposed by auditors in audits of financial statements. To accomplish this objective, the proposed SAS—
    - Adds an item to the list of matters generally addressed in the understanding with the client (the engagement letter). The new item states that management is responsible for adjusting the financial statements to correct material misstatements and for affirming to the auditor in the representation letter that the effects of any uncorrected misstatements brought to its attention by the auditor are not material, both individually and in the aggregate, to the financial statements taken as a whole. (Amends AU section 310.06 of SAS No. 1, *Codification of Auditing Standards and Procedures*, as amended by SAS No. 83, *Establishing an Understanding With the Client.*)
    - Requires the auditor to obtain, in the management representation letter, management's acknowledgement that it has considered the financial statement misstatements brought to its attention by the auditor and has concluded that any uncorrected misstatements are not

material, both individually and in the aggregate, to the financial statements taken as a whole. It also requires that a summary of the uncorrected misstatements be included in the representation letter or in an attachment thereto. (Amends SAS No. 85, *Management Representations.*)

- Requires the auditor to inform the audit committee about uncorrected misstatements brought to management's attention by the auditor that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole. (Amends SAS No. 61, *Communication With Audit Committees.*)

- *Reporting on Consistency.* The amendments in the second part of the proposed SAS clarify which changes in a reporting entity warrant a consistency explanatory paragraph in the auditor's report. They amend AU section 420, "Consistency of Application of Generally Accepted Accounting Principles," to—

  - Conform the list in AU section 420.07 of changes that constitute a change in the reporting entity to the guidance in paragraph 12 of Accounting Principles Board Opinion No. 20, *Accounting Changes.*
  - Clarify that the auditor need not add a consistency explanatory paragraph to the auditor's report when a change in the reporting entity results from a transaction or event, such as the purchase or disposition of a subsidiary.
  - Eliminate the requirement to add a consistency explanatory paragraph to the auditor's report when a pooling of interests is not accounted for retroactively in comparative financial statements. (However, in these circumstances the auditor would still be required to express a qualified or adverse opinion because of the departure from generally accepted accounting principles.)

- Eliminate the requirement to qualify the auditor's report and consider adding a consistency explanatory paragraph to the report if single-year financial statements that report a pooling of interests do not disclose combined information for the prior year.

- *Service Organizations.* The amendments in the third part of the proposed SAS are intended to help auditors determine what additional information they might need when auditing the financial statements of an entity that uses a service organization to process transactions. An example of a service organization is the trust department of a bank that invests and holds assets for an entity and generates information about those assets that is incorporated in the entity's financial statements. The proposed SAS amends SAS No. 70, *Reports on the Processing of Transactions by Service Organizations,* to—

    - Clarify the applicability of SAS No. 70 by stating that the SAS is applicable when the audited entity obtains services from another organization that are part of the entity's "information system." It also provides guidance on the types of services that would be considered part of an entity's information system.
    - Revise and clarify the factors a user auditor considers in determining the significance of a service organization's controls to a user organization's controls.
    - Clarify the guidance on determining whether information about a service organization's controls is necessary to plan the audit.
    - Clarify that information about a service organization's controls may be obtained from a variety of sources.
    - Change the title of SAS No. 70 from *Reports on the Processing of Transactions by Service Organizations to Service Organizations.*

At its meeting in September 1999, the ASB voted to issue the amendments related to consistency and service organizations. These amendments will be issued in early 2000, and will be effective upon issuance. The ASB decided to continue its consideration of the proposal on audit adjustments, particularly in light of the issuance of SEC Staff Accounting Bulletin No. 99, *Materiality.* The ASB plans to act on this matter by February 2000. If adopted, this proposal would be effective for audits of financial statements for periods ending on or after December 15, 2000.

A proposed SAS, *Amendments to Statements on Auditing Standard No., 61,* Communication With Audit Committees, and *Statement on Auditing Standards No. 71,* Interim Financial Information, was issued October 1, 1999. Visit http://www.aicpa.org/members/div/auditstd/drafts.htm for further information.

Proposed Statements on Quality Control Standards *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (a revision of Statement on Quality Control Standards No. 2) and *The Personnel Management Element of a Firm's System of Quality Control—Competencies Required by a Practitioner-in-Charge of an Attest Engagement were issued* June 17, 1999.

AcSEC Exposure Drafts

The following AcSEC exposure drafts were issued.

- Proposed Statement of Position—*Accounting for Discounts Related to Credit Quality* (Issued December 30, 1998)
- Proposed Statement of Position—*Accounting by Producers and Distributors of Films* (Issued October 16, 1998)
- Proposed Audit and Accounting Guide—*Audits of Investment Companies* (Issued September 22, 1998)
- Proposed Audit and Accounting Guide—*Life and Health Insurance Entities* (Issued September 4, 1998)

Professional Ethics Executive Committee Exposure Draft

The *Omnibus Proposal of Professional Ethics Division Interpretations and Rulings* was issued August 2, 1999.

Help Desk—See the AICPA Web site http://www.aicpa.org for a complete listing of outstanding exposure drafts for other AICPA documents.

FASB Statement Exposure Drafts

- Proposed Statement of Financial Accounting Standards —*Business Combinations and Intangible Assets* (Issued September 7, 1999)
- Proposed Statement of Financial Accounting Standards —*Accounting for Transfers of Financial Assets* (an amendment of FASB Statement no. 125) (Issued June 28, 1999)
- Proposed Statement of Financial Accounting Standards —*Consolidated Financial Statements: Purpose and Policy* (February 23, 1999)

Help Desk—See the FASB Web site http://www.fasb.org for a complete listing of outstanding exposure drafts for other FASB documents.

Guides and Audit Risk Alerts

AICPA Audit and Accounting Guides

Audit and Accounting Guides summarize the practices applicable to specific industries and describe relevant matters, conditions, and procedures unique to these industries. The accounting guidance included in AICPA Audit and Accounting Guides is in the GAAP hierarchy as authoritative GAAP. Guides are available from the AICPA for the following industries (product numbers are shown in parentheses):

- *Agricultural Producers and Cooperatives* 1999—(012354kk)
- *Airlines* 1999—(013183kk)
- *Banks and Savings Institutions* 1999—(011178kk)
- *Brokers and Dealers in Securities* 1999—(012181kk)
- *Casinos* 1999—(013150kk)

- *Common Interest Realty Associations* 1999—(012488kk)
- *Construction Contractors* 1999—(012096kk)
- *Credit Unions* 1999—(012060kk)
- *Employee Benefit Plans* 1999—(012339kk)
- *Entities With Oil and Gas Producing Activities* 1999—(012106kk)
- *Federal Government Contractors* 1998—(012437kk)
- *Finance Companies* 1999—(012466kk)
- *Health Care Organizations* 1999—(012440kk)
- *Investment Companies* 1998—(012362kk)[22]
- *Not-for-Profit Organizations* 1999—(013392kk)
- *Property and Liability Insurance Companies* 1999—(011922kk)
- *State and Local Governmental Units* 1999—(012059kk)
- *Stock Life Insurance Companies* 1994—(012035kk)[22]

The following general Audit and Accounting Guides also may be of interest to CPAs performing audit and attest engagements:

- *Consideration of Internal Control in a Financial Statement Audit* 1997—(012451kk)
- *Personal Financial Statements* 1999—(011136kk)
- *Prospective Financial Information* 1999—(011179kk)
- *Use of Real Estate Appraisal Information* 1997—(013159kk)

AICPA Industry Audit Risk Alerts

The annual industry Audit Risk Alert series provides information about current economic, regulatory, and professional developments in specified industries and practice areas. They assist CPAs in planning and performing audit engagements. The 1999/2000 Audit Risk Alerts are available from the AICPA for the following industries (product numbers are shown in parentheses):

- *Auto Dealerships*—(022233kk)
- *Compilation and Review*—(022240kk)
- *Construction Contractors*—(022235kk)
- *Common Interest Realty Associations*—(022234kk)
- *Depository and Lending Institutions*—(022236kk)
- *Employee Benefit Plans* 1999—(022214kk)
- *Health Care*—(022237kk)
- *High-Technology*—(022238kk)
- *Hospitality: Lodging and Restaurants*—(022252kk)
- *Insurance*—(022239kk)
- *Investment Companies*—(022241kk)
- *Not-for-Profit Organizations* 1999—(022215kk)
- *Real Estate*—(022242kk)
- *Retail Enterprises*—(022243kk)
- *Securities*—(022244kk)
- *State and Local Governments* 1999—(022247kk)

Other Accounting and Auditing Team Publications

Audit and Accounting Manual (007258kk). The manual is a valuable nonauthoritative practice tool designed to provide assistance for audit, review, and compilation engagements. It contains numerous practice aids, samples, and illustrations —including audit programs; sample opinions; checklists; and sample engagement, management representation, and confirmation letters.

[22] New Guides are expected to be issued in the near future.

Also included is a special section for state and local governmental engagements.

AICPA Practice Aid Series. The publications that constitute the AICPA Practice Aid Series have been designed to address a broad range of topics that affect today's CPA. From enhancing the efficiency of your practice to developing the new skill sets required for a successful transition to meet the challenges of the new millennium, this series provides practical guidance and information to assist in making sense out of a changing and complex business environment. The series includes the following:

- *Preparing and Reporting on Cash- and Tax-Basis Financial Statements* (006701kk)
- *Financial Statement Reporting and Disclosure Practices for Employee Benefit Plans* (008725kk)
- *Auditing Recipients of Federal Awards: Practical Guidance for Applying OMB Circular A-133 Audits of States, Local Governments, and Non-Profit Organizations June 1997 revisions* (008730kk)
- *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82* (008883kk)
- *Auditing Estimates and Other Soft Accounting Information* (010010kk)
- *Make Audits Pay—Leveraging the Audit into Consulting Services* (006704kk)
- *CPA ElderCare: A Practitioner's Resource Guide* (022504kk)
- *Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools* (006600kk)
- *Financial Statement Presentation and Disclosure Practices for Not-for-Profit Organizations* (006605kk)

Also look for *Understanding and Implementing GASB's New Financial Reporting Model—A Question and Answer Guide for*

Preparers and Auditors of State and Local Governmental Financial Statements (022515kk).

The following publications are in development:

- *CPA WebTrust Practitioners Guide*
- *CPA Performance View*
- *Auditing Financial Instruments—Practical Guidance for Applying the new SAS on Financial Instruments* (Draft excerpts can be downloaded at http://www.aicpa.org/members/div/auditstd/webmater.htm)
- *Updates to CPA ElderCare: A Practitioner's Resource Guide*

New Series—Assurance Services Alerts. The newly introduced Assurance Services Alert series provides practitioners with information about the emerging practice areas of CPA ElderCare services and CPA WebTrust. These Alerts provide both an introduction to those who are unfamiliar with assurance services and an update of important new developments for those who have expanded their practice to include these assurance services. The 1999 Assurance Services Alerts are available from the AICPA for the following services (product numbers are shown in parentheses):

- *CPA WebTrust*—1999 (022231kk)
- *CPA ElderCare Services*—1999 (022232kk)

Financial Statement Preparation Manual/Disclosure Checklists (G01027kk). This manual is a loose-leaf service consisting of nineteen industry specific disclosure checklists and includes sample financial statements. It is updated annually to reflect the issuance of new authoritative guidance. Most of the checklists are also available in individual paperback versions.

Accounting Trends and Techniques—1999 (009890). This publication offers highlights of the latest trends in corporate financial statements are presented for practitioners in industry and public practice. The publication, which is based on a survey of over six hundred public companies, illustrates accounting practices and trends, including presentations and disclosures.

Auditing Practice Releases

Auditing Practice Releases provide auditors of financial statements with practical guidance on specific subject areas. These nonauthoritative publications help auditors understand complex issues encountered and suggest procedures to accomplish audit objectives.

- *Audit Implications of Electronic Data Interchange* (021060kk)
- *The Information Technology Age: Evidential Matter in the Electronic Environment* (021068kk)
- *Confirmation of Accounts Receivable* (021064kk)
- *Audit Implications of Electronic Document Management* (021066kk)
- *Service Organizations: Applying SAS No. 70* (021056kk)
- *Analytical Procedures* (021069kk)
- *Auditing in Common Computer Environments* (021059kk)
- *Auditing with Computers* (021057kk)
- *Consideration of the Internal Control Structure in a Computer Environment: A Case Study* (021055kk)
- *Audits of Inventories* (021045kk)
- *Audit Sampling* (021061kk)

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Accounting and Auditing Technical Hotline

The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call 888-777-7077.

Ethics Hotline

Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call 888-777-7077.

World Wide Web Site

The AICPA has a home page on the World Wide Web. "AICPA Online," the Web site (URL or uniform resource locator: http://www.aicpa.org), offers CPAs the unique opportunity to stay abreast of developments in accounting and auditing, including exposure drafts. The Web site includes *In Our Opinion*, the newsletter of the AICPA Audit and Attest Standards Team. The newsletter provides valuable and timely information on technical activities and developments in auditing and attestation standard setting.

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The AICPA is currently offering a new CD-ROM product, entitled *reSource: AICPA's Accounting and Auditing Literature*. This CD-ROM enables subscription access to the following AICPA Professional Literature products in a Windows format: *Professional Standards*, *Technical Practice Aids*, and *Audit and Accounting Guides* (available for purchase as a set which includes all Guides and the related Audit Risk Alerts, or as individual publications). This dynamic product allows you to purchase the specific titles you need, and includes hypertext links to references within and between all products. To order any publications included on the CD-ROM, call 888-777-7077.

Practitioners Publishing Company (PPC) and the AICPA are currently offering publications issued by PPC, the AICPA, and the FASB on one CD-ROM disk, entitled *The Practitioner's Library—Accounting and Auditing.* The FASB publications include *Original Pronouncements, Current Text, Emerging Issues Task Force Abstracts*, and *FASB Implementation Guides*; and the AICPA publications include *Professional Standards*, *Technical Practice Aids, Audit and Accounting Guides*, and *Peer Review Program Manual.* The disk also contains eighteen PPC engagement manuals. The disk may be customized so that purchasers pay for and receive only selected segments of the material. For more information about this product call 800-323-8724.

APPENDIX A

The Internet—An Auditor's Research Tool

Some Web sites that may provide valuable information to auditors are listed in the following table:

Name of Site	*Content*	*Internet Address*
American Institute of CPAs	Summaries of recent auditing and other professional standards as well as other AICPA activities	http://www.aicpa.org
Financial Accounting Standards Board	Summaries of recent accounting pronouncements and other FASB activities	http://www.fasb.org
Governmental Accounting Standards Board	Summaries of recent accounting pronouncements and other GASB activities	http://www.gasb.org
Securities and Exchange Commission	SEC Digest and Statements, EDGAR database, current SEC rulemaking	http://www.se6gov
Independence Standards Board	Information on the activities of the Independence Standards Board	http://www.cpa independence.org
The Electronic Accountant	World Wide Web magazine that features up-to-the-minute news for accountants	http://www. electronicaccountant.com
CPAnet	Links to other Web sites of interest to CPAs	http://www.cpalinks.com
Guide to WWW for Research and Auditing	Basic instructions on how to use the Web as an auditing research tool	http://www.tetranet. net/users/gaostl/ guide.htm
Accountant's Home Page	Resources for accountants and financial and business professionals	http://www. computercpa.com
U.S. Tax Code Online	A complete text of the U.S. Tax Code	http://www.fourmilab. ch/ustax/ustax.html

(continued)

Name of Site	*Content*	*Internet Address*
Federal Reserve Bank of New York	Key interest rates	http://www.ny.frb.org/pihome/statistics/dlyrates
Cybersolve	Online financial calculators such as ratio and breakeven analysis	http://www.cybersolve.com/tools1.html
XFRML—the digital language of business	Information on the development of a standards-based method to prepare, publish in a variety of formats, exchange and analyze financial reports and the information they contain.	http://www.xfrml.org
Hoovers Online	Online information on various companies and industries	http://www.hoovers.com
Ask Jeeves	Search engine that utilizes a user-friendly question format. Provides simultaneous search results from other search engines as well (e.g., Excite, Yahoo, AltaVista)	http://www.askjeeves.com
Vision Project	Information on the profession's vision project	http://www.cpavision.org/horizon

The Audit Risk Alert is published annually. As you encounter audit issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share those with us. Any other comments that you have about the Audit Risk Alert would also be greatly appreciated. You may send these comments to:

George Dietz, CPA
AICPA
Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311-3881

Or email to GDietz@aicpa.org